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AIRLINE FINANCIAL STABILITY

HEARING

BEFORE THE

SUBCOMMITTEE ON AVIATION

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

JULY 13, 2005

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AIRLINE FINANCIAL STABILITY

WEDNESDAY, JULY 13, 2005

U.S. SENATE,
SUBCOMMITTEE ON AVIATION,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 9:58 a.m., Senate Russell 253, Hon. Conrad Burns, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF HON. CONRAD BURNS, U.S. SENATOR FROM MONTANA

Senator BURNS. We'll call the Committee to order this morning, and there are quite a lot of things going on in this part of the world, and we want to thank our folks for coming in this morning. I welcome this panel of witnesses, and especially in our continuing efforts to work toward ideas for the next FAA reauthorization bill, we are examining the financial condition of the airline industry. It is our intent to focus on a wide array of internal and external factors that shape the industry today. I think it's important this subcommittee understands the underlying principles, and problems in the industry in order to make an educated policy decision. As you know, as policymakers, we should operate with the idea to do no harm, and when we do know there are extenuating circumstances under legislation and sometimes we don't see it coming.

There are certainly several caveats to the airline industry. I anticipate that we will discuss them, among others, the relationship between the legacy carriers and the low-cost carriers, so-called rising fuel costs, aviation taxes and fees, labor and management relations, capacity concerns, fair pricing, aircraft leasing, industry consolidation, and the role that Chapter 11 bankruptcy plays in the industry. As if there is not enough on the platter already, this sort of fills the boat.

Since 2000, many in the airline industry have experienced poor financial results and have lost somewhere around $35 billion with the expectation of heavy losses this year. A majority of those problems can be traced back to the horrific events of 9/11 and SARS, but there are also several factors that were in place, and starting to evolve prior to 9/11.

Legacy carriers—the business models—have been criticized for years, but the fragile line between profitability and red ink was not exposed until we had seen the events of 9/11, and the effects of that along with the downturn of the overall economy. One could

argue that we are starting to see the actual results of deregulation now much more than the 1980s and 1990s.

We now have prospering, low-cost carriers, evolving business, and aviation ventures, and because of it, more people are flying today. In fact, just last month we had a hearing on passenger levels and system capacity. Our traffic levels are back to record levels, planes are full, but many of the legacy carriers are still seriously struggling.

It's tough to understand why, in a business that seems to be booming, most of the legacy carriers are busting. For a Senator from Montana, it's even more disconcerting to see our legacy traditional hub-and-spoke carriers in dire straits. The hub-and-spoke model has provided historical foundation for rural access to my state and many others that do not fit into the traditional low-cost carrier business plan. Legacy carriers are making significant gains in improving their bottom lines, but still reporting large financial losses. Today we look at some of the reasons why.

Our panel consists of a broad spectrum of aviation experts, and I look forward to their testimony. This morning I want to thank them for coming, because we know the industry is vitally important to this country for commerce and I know you take your job very, very seriously. Senator Inouye, thank you for coming in this morning, also.

STATEMENT OF HON. DANIEL K. INOUYE, U.S. SENATOR FROM HAWAII

Senator INOUYE. Well, I thank you very much. I have a prepared statement I'd like to have made part of the record. Like a few of my colleagues, I do a lot of flying. In fact, last week, I spent more time in the air than on the ground. I spent 20 hours in Hawaii and 22 hours in the air. And so I'm well aware of the low fares. I'm well aware of the packed aircraft, and, yet, I know that since 2001, we have a shortfall of $35 billion. About 150,000 have lost their jobs, so this is a serious situation, and we are looking for answers, and I would like to commend my Chairman for calling this hearing.

[The prepared statement of Senator Inouye follows:]

PREPARED STATEMENT OF HON. DANIEL K. INOUYE, U.S. SENATOR FROM HAWAII

Most aviation observers understand that despite the low fares and packed airplanes that have become commonplace, the Nation's airlines continue to struggle through the toughest financial period in the history of commercial aviation. This has not been a blip on the proverbial radar screen.

This has been an extended economic slump that resulted in the collective loss of tens of billions of dollars by the major carriers and the elimination of nearly 150,000 airline jobs over the past four years.

Most Americans recognize how important a healthy aviation industry is for a country as large as the U.S. However, it is often easy to forget the complex factors affecting our airlines, particularly, when planes generally run on schedule and move passengers thousands of miles in a fraction of the time that other modes require.

In my home State of Hawaii, the service air carriers provide is vital to our way of life. Hawaii residents use planes as a primary mode of transportation. Many do so on a daily basis as part of their commute to and from work.

Whether travel, tourism, or trade, in Hawaii, we depend on the commercial aviation industry to provide us with timely contact between the islands, the continental U.S., and the rest of the world. Yet our two primary airlines, Hawaiian and Aloha, have operated under bankruptcy protection for much of the past two years. Their precarious financial situation has constantly threatened significant service disruptions, which would be devastating to the local economy.

Hawaii primarily counts on major carriers for service beyond our borders, and like our local carriers, these airlines are facing great financial difficulties.

When the Federal Government shut down the Nation's airspace for several days following the 9/11 attacks, most Americans experienced a temporary limit to their mobility in the wake of the tragedy. For the people of Hawaii, the shutdown directly and immediately impacted their livelihoods. For those needing medical assistance or facing subsequent emergencies, it became a matter of life or death.

There are many rural or isolated communities that could face similar circumstances if a local airline fails or their access to the National Airspace System is reduced in the wake of extreme cost-cutting measures. In a globalized economy reliant upon air travel, the impact to rural communities could be increasingly detrimental. We must continually work to ensure that all of our citizens have a fair opportunity to access this nation's unparalleled aviation infrastructure.

I wish to take this opportunity to recognize the employees in the aviation industry. They have been especially resilient during this difficult period. They have seen nearly one-third of all airline jobs eliminated, and virtually every employee has seen their pay and benefits reduced. They understand intimately the importance of this industry and have gone above and beyond to see that it survives.

Unfortunately, if we do not begin to solve the problems plaguing the air carriers, we will see more failures in coming months and certainly more jobs cut. The combination of excess capacity, record gas prices, and a market flush with consistent, low fares has effectively neutralized the major carriers' intense, cost-cutting measures. The Bush Administration's effort to add additional security and pension fees has not been helpful either.

The U.S. airline industry is now at a crossroad. Some legacy carriers have spent the last few years aggressively working to compete will the budget carriers and are now approaching profitability. They are beginning to prove that they can adapt and survive. Yet at the same time, factors like spiraling gas prices are pushing others to the brink of bankruptcy or limiting their ability to get out of it.

The financial stability of the airlines is one of the most important issues that we face this session. We must carefully consider the needs of the industry as a whole, make certain that urban, suburban, and rural communities can access air travel, and advance forward-thinking initiatives that will help ensure a prosperous, vibrant aviation industry for decades to come.

Senator BURNS. Thank you very much, Senator, and your full statement will be made part of the record. We'll just take the panel now this morning. As it's listed here, Ms. JayEtta Z. Hecker, Director of Physical Infrastructure Issues, U.S. Government Accounting Office, GAO, and we welcome you this morning and look forward to your testimony. By the way, we would like to condense some of this. You bring up the highlights and then we'll put your full statement in the record. Thank you.

STATEMENT OF JAYETTA Z. HECKER, DIRECTOR, PHYSICAL INFRASTRUCTURE ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Ms. HECKER. Thank you, Mr. Chairman. Senator Inouye, I'm very pleased to be here today. As you know, we've been conducting analyses of the airline industry at the direction of Congress for a number of years. We had a prior report last year that talked about the factors that were leading to the extremely difficult financial condition. The current work that I'm reporting on is focusing on bankruptcy and pension issues in airlines and my remarks—I do have a slide presentation. I don't know if you have that. It may be useful because I have a number of charts that I think tell the story.

Senator BURNS. We all have copies, I think, and as you know, this is a technology committee, of which we have none.

Ms. HECKER. Hopefully paper will work in this instance. The two topics are the financial difficulties faced by the legacy carriers and

the major factors behind them, and then the effect of bankruptcy on the industry and competitors.

On the first topic, there is, of course, no secret that the airlines face severe financial difficulties. There has been not only the significant change in demand, particularly the increased price sensitivity of business travelers, but there have also been enormous changes in the competitive environment where low-cost carriers now are available to 85 percent of all passengers. The low-cost carriers are really the price setters and have transformed their competitive environment in the airline industry.

This really has led to the major effort by the legacy carriers to control costs, and the next slide, the one with the two lines, basically outlines the changes in the costs for available seat-miles for both the legacy carriers and the low-cost carriers, and you see they were going up until 2001, and then both were coming down, but the main point is that the difference has actually increased, so as the low-cost carriers have continued to expand, their costs-per-seat-mile have actually gone down, and the difference—the cost disadvantage—has actually increased, and you see the factors there, labor, pensions, fuel, and a wide variety of other factors.

Of course, the next page shows the fuel prices, and there is no doubt the prior page said that the difference, this is not the total fuel, but the difference in the fuel costs for low-cost carriers, they actually had a fuel advantage, more fuel efficient airplanes and more efficient use of airplanes, so all of the costs have been hurt by these rising prices, but, of course, on a differential basis. My main point is really this next chart about fixed obligations, and what is important here is its absence of the liquidity that really drives carriers into bankruptcy, along with inability to renegotiate obligations and acquire new capital.

The first column is the cash on hand at the end of 2004 and then the next four bars basically outline the fixed obligations. These are fixed. These are not flexible with changing your business model, and how they severely strain and overpower the amount of cash on hand. The other thing is to see how diverse these factors are. There has been a lot of talk about pensions. Pensions is only one-sixth of the fixed obligation overhang that is so threatening the financial condition of the major carriers.

The second objective, then, is to look at the whole issue of bankruptcy. There is widespread expectation of presumption that bankruptcy was used to harm competitors by either lowering prices or keeping capacity in the market longer. Our first chart on page 8 basically outlines how bankruptcy and liquidations are more common in the airline industry. In fact, the airline industry is one of the worst performing sectors of all, and what we have here is, not only is the rate of bankruptcy and liquidation more common, but the potential to recover is also more difficult for carriers.

Our data shows that of 160 bankruptcies since 1978, only 20 have actually survived to this day. Another factor we found is the airline bankruptcies last longer, and as I said have these less successful outcomes. The next, page 9, is this growth of airline industry capacity and charted along with major airline liquidations, and the point here is that we found little evidence that bankruptcies are actually contributing to the overcapacity. As you see, it's really

those gray areas, it's the recessions that have been the only factors that lead to decreases in industry capacity.

We have concluded that bankruptcies are not looked at for competitive advantage. It's not a panacea. It involves many costs, many risks, and in our view is looked at by firms as a last resort. And if anything, the poor history really is a testimony to that.

Our concluding observations then is that we, as you said, Mr. Chairman, the industry is really still playing out the deregulation policies of the 1970s. The restructuring is continuing. The emergence, the full, powerful, ever present emergence of low-cost carriers, as I said, is available to 85 percent of the population, and the legacy carriers profitability depends on controlling those costs where they still have that disadvantage.

An important part of our conclusion, contrary to what is seen as accepted wisdom, bankruptcy and liquidation are a reflection of, but not the cause of industry stability, and in our view, some carriers will terminate pension plans through the bankruptcy process under the current conditions. Our most focused observation is this last point, though, and it's the terminating pensions or amortizing their contributions over a longer period will not solve the underlying legacy problems, fundamental structural concerns and cost disadvantage, so even though there may be a potential for a temporary reprieve, it is only a limited part of the liquidity problem, and the cost-differential, and, thus, in our view, there shouldn't be a sense that there is a silver bullet to somehow fix the dire financial condition of the legacy carriers. That concludes my remarks, Mr. Chairman.

[The prepared statement of Ms. Hecker follows:]

PREPARED STATEMENT OF JAYETTA Z. HECKER, DIRECTOR, PHYSICAL INFRASTRUCTURE ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. Chairman and members of the Subcommittee:

We appreciate the opportunity to participate in today's hearing to discuss the financial condition of the U.S. airline industry—and particularly, the financial problems of legacy airlines.[1] Since 2001, the U.S. airline industry has confronted financial losses of unprecedented proportions. From 2001 through 2004, legacy airlines reported losses of $28 billion, and two of the nation's largest legacy airlines—United Airlines and US Airways—went into bankruptcy,[2] eventually terminating their pension plans, and passing the unfunded liability to the Pension Benefit Guaranty Corporation (PBGC).[3] Two other large legacy airlines have announced that they are precariously close to following suit.

In recent years, considerable debate has ensued over legacy airlines' use of Chapter 11 bankruptcy protection as a means to continue operations, often for years. Some in the industry and elsewhere have maintained that legacy airlines' use of this approach is harmful to the airline industry as a whole, in that it allows inefficient carriers to stay in business, exacerbating overcapacity and allowing these airlines to potentially under-price their competitors. This debate has received even sharper focus with US Airways' and United's defaults on their pensions. By eliminating their pension obligations, critics argue, US Airways and United enjoy a cost advantage that may encourage other airlines sponsoring defined benefits plans to take the same approach.

Last year, we reported on the industry's poor financial condition, the reasons for it, and the necessity of legacy airlines to reduce their costs if they are to survive.[4] At the request of the Congress, we have continued to assess the financial condition of the airline industry, and, in particular, the problems of bankruptcy and pension terminations. Our work in this area is still under way.[5] Nonetheless, we can offer some preliminary observations about what we are finding. Our statement today describes our preliminary observations in three areas: (1) the continued financial difficulty faced by legacy airlines, (2) the effect of bankruptcy on the industry and competitors, and (3) the effect of airline pension underfunding on employees, retirees,

airlines, and the PBGC. Our final report, which we expect to issue in September, will offer additional evidence and insights on these questions.

In summary:

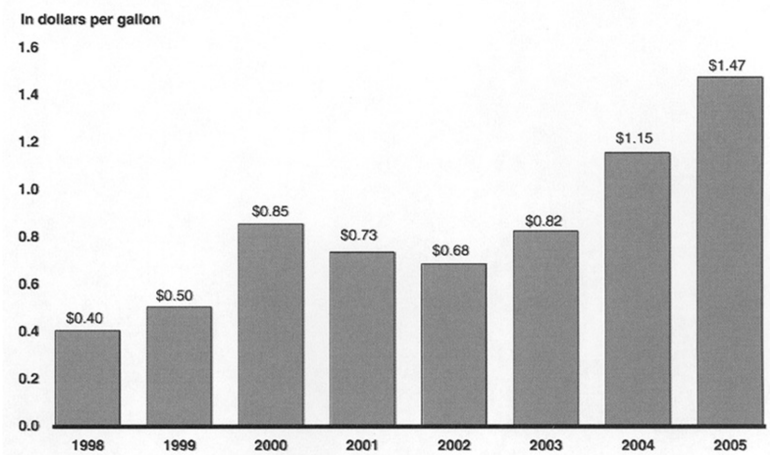
- U.S. legacy airlines have not been able to reduce their costs sufficiently to profitably compete with low-cost airlines that continue to capture industry market share. Challenges that are internal and external to the industry have fundamentally changed the nature of the industry and forced legacy airlines to restructure themselves financially. The changing demand for air travel and growth of low-cost airlines has kept fares low, forcing legacy airlines to reduce their costs. However, legacy airlines have struggled to do so, and have been unable to achieve unit-cost comparability with their low-cost rivals. As a result, legacy airlines have continued to lose money—$28 billion since 2001—and are expected to lose another $5 billion in 2005. Additionally, airlines' costs have been hurt by rising fuel prices—especially legacy airlines that did not have fuel hedging in place.
- Bankruptcies are endemic to the airline industry, the result of long-standing structural issues within the industry, but there is no clear evidence that bankruptcy itself has harmed the industry or its competitors. Since deregulation in 1978, there have been 160 airline bankruptcy filings, 20 of which have occurred in the last 5 years. Airlines fail at a higher rate than most other types of companies, and the airline industry historically has the worst financial performance of any sector. This inherent instability that leads to so many bankruptcies can be traced to the structure of the industry and its economics, including the highly cyclical demand for air travel, high fixed costs, and few barriers to entry. The available evidence does not suggest that airlines in bankruptcy contribute to industry overcapacity, or that bankrupt airlines harm competitors by reducing fares below what other airlines are charging. The history of the industry since deregulation indicates that past liquidations or consolidations have not slowed the overall growth of capacity in the industry. Studies conducted by others do not show evidence that airlines operating in bankruptcy harmed other competitors. Finally, while bankruptcy may appear to be a useful business strategy for companies in financial distress, available analysis suggests it provides no panacea for airlines. Few airlines that have filed for bankruptcy protection are still in business today. Bankruptcy involves many costs, and given the poor track record, companies are likely to use it only as a last resort.
- While bankruptcy may not harm the financial health of the airline industry, it has become a considerable concern for the Federal Government and airline employees and retirees because of the recent terminations of pensions by US Airways and United Airlines. These terminations resulted in claims on PBGC's single-employer program of $9.6 billion and plan participants (i.e., employees, retirees, and beneficiaries) are estimated to have lost more than $5 billion in benefits that were either not covered by PBGC, or exceeded the statutory limits. At termination in May 2005, United's pension plans promised $16.8 billion in benefits backed by only $7 billion in assets (i.e., it was underfunded by $9.8 billion). PBGC guaranteed $13.6 billion of the promised benefits, resulting in a claim on the agency of $6.6 billion and an estimated $3.2 billion loss to participants. The defined benefit pension plans of the remaining legacy airlines with active plans are underfunded by $13.7 billion (based on data from the U.S. Securities and Exchange Commission, or SEC), raising the potential of additional sizeable losses to PBGC and plan participants. These airlines face $10.4 billion in pension contributions over the next 4 years, significantly more than some of them may be able to afford given continued losses and their other fixed obligations. Spreading these contributions over more years, as some of these airlines have proposed, would relieve some of this liquidity pressure but would not necessarily keep them out of bankruptcy because it does not fully address the fundamental cost structure problems faced by legacy airlines.

Legacy Airlines Must Reduce Costs To Restore Profitability

Since 2000, legacy airlines have faced unprecedented internal and external challenges. Internally, the impact of the Internet on how tickets are sold and consumers search for fares and the growth of low-cost airlines as a market force accessible to almost every consumer has hurt legacy airline revenues by placing downward pressure on airfares. More recently, airlines' costs have been hurt by rising fuel prices (see figure 1).[6] This is especially true of airlines that did not have fuel hedging in place. Externally, a series of largely unforeseen events—among them the September 11th terrorist attacks in 2001 and associated security concerns; war in Iraq; the

SARS crisis; economic recession beginning in 2001; and a steep decline in business travel—seriously disrupted the demand for air travel during 2001 and 2002.

Figure 1: Average Annual Spot Price for Gulf Coast Jet Fuel, 1998-2005

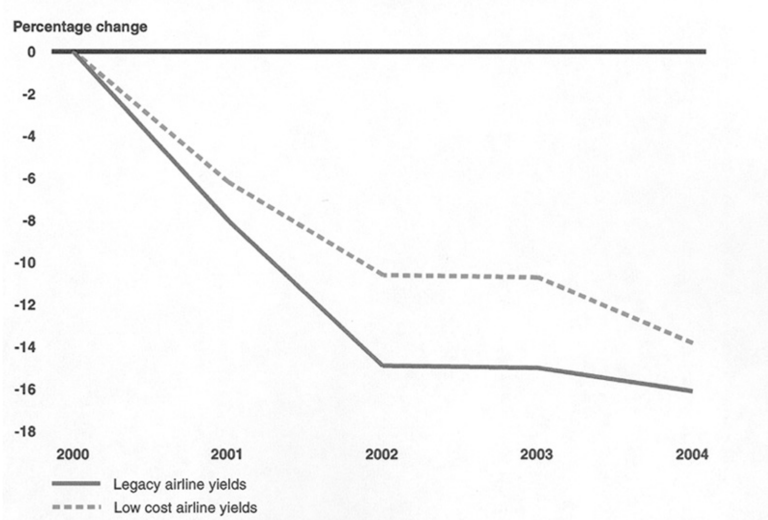


Source: GAO analysis of Department of Energy's Energy Information Administration data.

Note: 2005 prices reflect average through June 7.

Low fares have constrained revenues for both legacy and low-cost airlines. Yields, the amount of revenue airlines collect for every mile a passenger travels, fell for both low-cost and legacy airlines from 2000 through 2004 (see figure 2). However, the decline has been greater for legacy airlines than for low-cost airlines. During the first quarter of 2005, average yields among both legacy and low-cost airlines rose somewhat, although those for legacy airlines still trailed what they were able to earn during the same period in 2004.

Figure 2: Percentage Change in Passenger Yields Since 2000

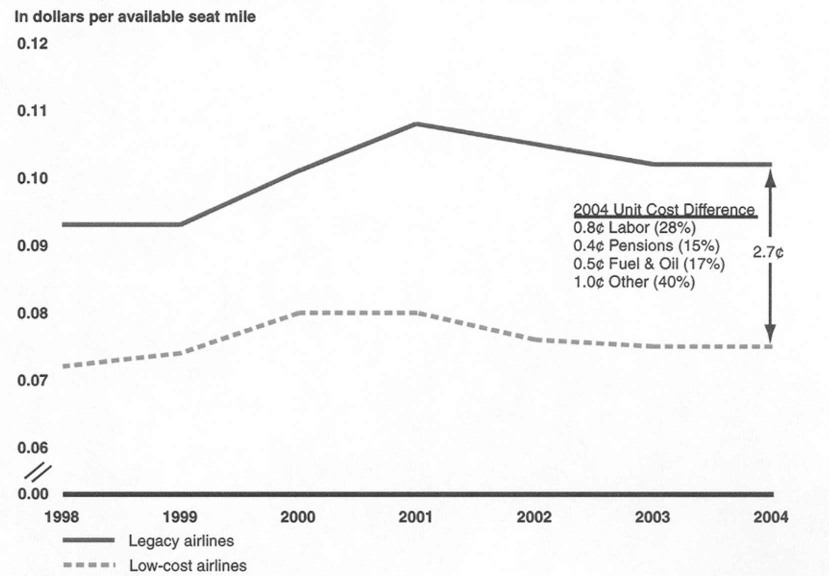


Source: GAO analysis of Department of Transportaion (DOT) Form 41 data.

Legacy airlines, as a group, have been unsuccessful in reducing their costs to become more competitive with low-cost airlines. Unit cost competitiveness is key to

profitability for airlines because of declining yields. While legacy airlines have been able to reduce their overall costs since 2001, these were largely achieved through capacity reductions and without an improvement in their unit costs. Meanwhile, low-cost airlines have been able to maintain low unit costs, primarily by continuing to grow. As a result, low-cost airlines have been able to sustain a unit cost advantage as compared to their legacy rivals (see figure 3). In 2004, low-cost airlines maintained a 2.7 cent per available seat-mile advantage over legacy airlines. This advantage is attributable to lower overall costs and greater labor and asset productivity. During the first quarter of 2005, both legacy and low-cost airlines continued to struggle to reduce costs, in part because of the increase in fuel costs.

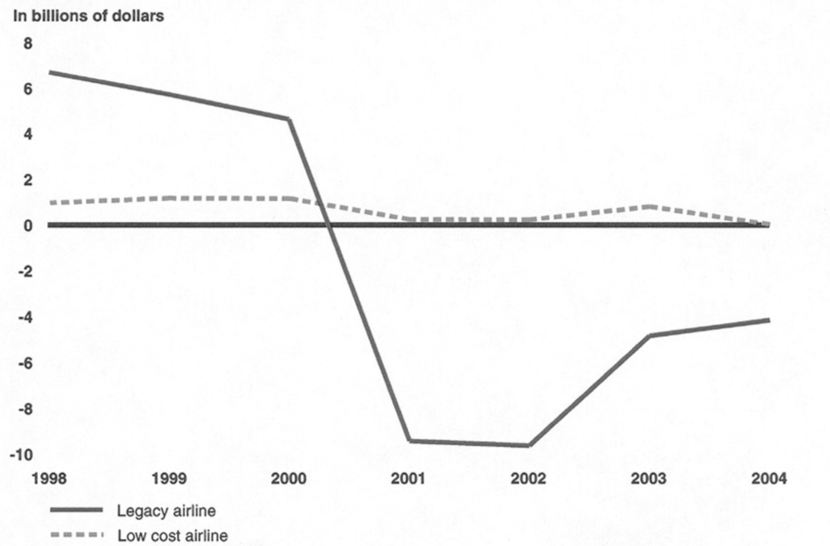
Figure 3: Legacy vs. Low Cost Airline Unit Cost Differential, 1998 2004



Source: GAO analysis of DOT Form 41 data.

Weak revenues and the inability to realize greater unit cost-savings have combined to produce unprecedented losses for legacy airlines. At the same time, low-cost airlines have been able to continue producing modest profits as a result of lower unit costs (see figure 4). Legacy airlines have lost a cumulative $28 billion since 2001 and are predicted to lose another $5 billion in 2005, according to industry analysts. First quarter 2005 operating losses (based on data reported to DOT) approached $1.45 billion for legacy airlines. Low cost airlines also reported net operating losses of almost $0.2 billion, driven primarily by ATA's losses.

Figure 4: Airline Operating Profits and Losses, 1998-2004



Source: GAO analysis of DOT Form 41 data.

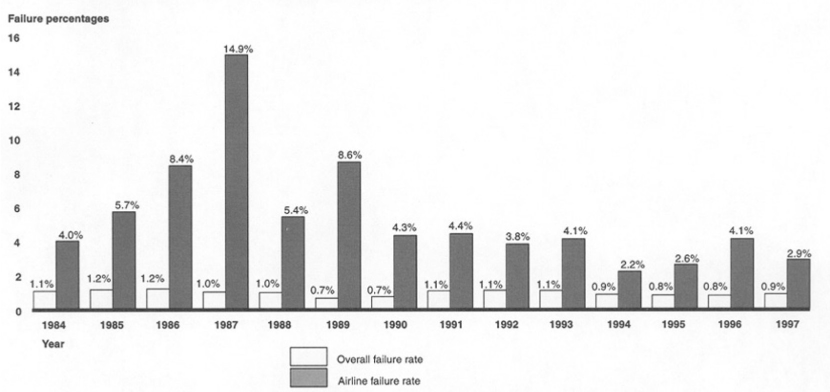
Since 2000, as the financial condition of legacy airlines deteriorated, they built cash balances, not through operations, but by borrowing. Legacy airlines have lost cash from operations, and compensated for operating losses by taking on additional debt, relying on creditors for more of their capital needs than in the past. In the process of doing so, several legacy airlines have used all, or nearly all, of their assets as collateral, potentially limiting their future access to capital markets.

In sum, airlines are capital- and labor-intensive firms subject to highly cyclical demand and intense competition. Aircraft are very expensive and require large amounts of debt financing to acquire, resulting in high fixed-costs for the industry. Labor is largely unionized and highly specialized, making it expensive and hard to reduce during downturns. Competition in the industry is frequently intense owing to periods of excess capacity, relatively open entry, and the willingness of lenders to provide financing. Finally, demand for air travel is highly cyclical, closely tied to the business cycle. Over the past decade, these structural problems have been exacerbated by the growth in low-cost airlines and increasing consumer sensitivity to differences in airfares based on their use of the Internet to purchase tickets. More recently, airlines have had to deal with persistently high fuel prices—operating profitability, excluding fuel costs, is as high as it has ever been for the industry.

Bankruptcy Is Common in the Airline Industry, but There Is No Evidence That it Is Harmful to the Industry or Competitors

Airlines seek bankruptcy protection for such reasons as severe liquidity pressures, an inability to obtain relief from employees and creditors, and an inability to obtain new financing, according to airline officials and bankruptcy experts. As a result of the structural problems and external shocks previously discussed, there have been 160 total airline bankruptcy filings since deregulation in 1978, including 20 since 2000, according to the Air Transport Association.[7] Some airlines have failed more than once, but most filings were by smaller carriers. However, the size of airlines that have been declaring bankruptcy has been increasing. Of the 20 bankruptcy filings since 2000, half of these have been for airlines with more than $100 million in assets, about the same number of filings as in the previous 22 years. Compared to the average failure rate for all types of businesses, airlines have failed more often than other businesses. As figure 5 shows, in some years, airline failures were several times more common than for businesses overall.

Figure 5: Comparison of Airline and Overall Business Failure Rates, 1984-1997



Source: GAO analysis of DOT and Dun & Bradstreet data.

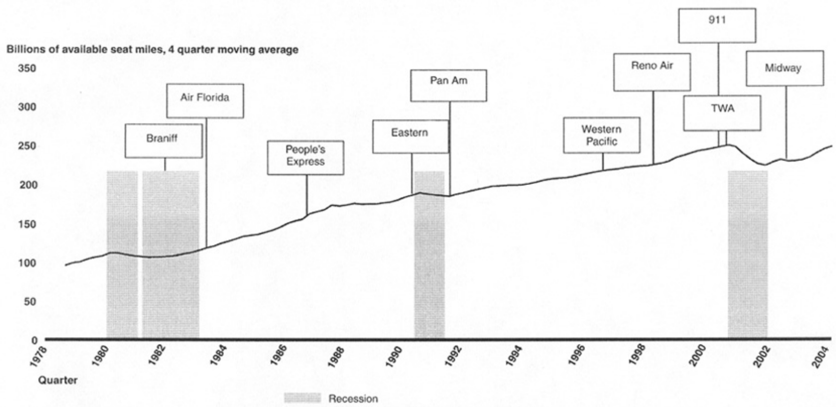
Note: Dun & Bradstreet data were only available through 1997.

With very few exceptions, airlines that enter bankruptcy do not emerge from it. Of the 146 airline Chapter 11 reorganization filings since 1979, in only 16 cases are the airlines still in business. Many of the advantages of bankruptcy stem from legal protection afforded the debtor-airline from its creditors, but this protection comes at a high cost in loss of control over airline operations and damaged relations with employees, investors, and suppliers, according to airline officials and bankruptcy experts.

Contrary to some assertions that bankruptcy protection has led to overcapacity and under-pricing that have harmed healthy airlines, we found no evidence that this has occurred either in individual markets or to the industry overall. Such claims have been made for more than a decade. In 1993, for example, a national commission to study airline industry problems cited bankruptcy protection as a cause for the industry's overcapacity and weakened revenues.[8] More recently, airline executives have cited bankruptcy protection as a reason for industry over-capacity and low fares. However, we found no evidence that this had occurred and some evidence to the contrary.

First, as illustrated by Figure 6, airline liquidations do not appear to affect the continued growth in total industry capacity. If bankruptcy protection leads to overcapacity as some contend, then liquidation should take capacity out of the market. However, the historical growth of airline industry capacity (as measured by available seat-miles, or ASMs) has continued unaffected by major liquidations. Only recessions, which curtail demand for air travel, and the September 11th attack, appear to have caused the airline industry to trim capacity. This trend indicates that other airlines quickly replenish capacity to meet demand. In part, this can be attributed to the fungibility of aircraft and the availability of capital to finance airlines.[9]

Figure 6: Growth of Airline Industry Capacity and Major Airline Liquidations Billions of ASMs, Moving Quarterly Average, 1978-2003



Source: Bankruptcy filings, media reports, and DOT Form 41 data.

Note: Figure does not show liquidations of smaller airlines.

Similarly, our research does not indicate that the departure or liquidation of a carrier from an individual market necessarily leads to a permanent decline in traffic for that market. We contracted with Inter*VISTAS*-ga[2], an aviation consultant, to examine the cases of six hub cities that experienced the departure or significant withdrawal of service of an airline over the last decade (see table 1). In four of the cases, both local origin-and-destination (i.e., passenger traffic to or from, but not connecting through, the local hub) and total passenger traffic (i.e., local and connecting) increased or changed little because the other airlines expanded their traffic in response. In all but one case, fares either decreased or rose less than 6 percent.

Table 1: Case Examples of Markets' Response to Airline Withdrawals

Market	Year	Airline	Effect on passenger traffic	Change in fares (percent)
Nashville, TN	1995	American Airlines eliminated hub.	Other airlines' traffic increased. Origin and destination traffic increased.	−10.2
Greensboro, NC	1995	Continental Lite eliminated hub.	Other airlines' traffic increased. Origin and destination traffic decreased.	+5.5
Colorado Springs, CO	1997	Western Pacific moved operations to Denver.	Other airlines' traffic decreased. Origin and destination traffic decreased.	+43.6
St. Louis, MO	2001	TWA acquired by American Airlines.	Other airlines' traffic decreased. Little change in origin and destination traffic.	+5.4
Kansas City, MO	2002	Vanguard Airlines suspended service.	Little change in other airlines' traffic. Little change in origin and destination traffic.	+4.2
Columbus, OH	2003	America West eliminated hub.	Other airlines' traffic increased. Little change in origin and destination traffic.	+3.6

Source: Inter*VISTAS*-ga[2].
Note: Little change in traffic means that traffic increased or decreased less than 5 percent and that origin-and-destination traffic increased or decreased less than 10 percent. Changes in passenger traffic and fares are measured from 4 quarters prior to the airline departure to 8 quarters after.

We also reviewed numerous other bankruptcy and airline industry studies and spoke to industry analysts to determine what evidence existed with regard to the impact of bankruptcy on the industry. We found two major academic studies that provided empirical data on this issue. Both studies found that airlines under bankruptcy protection did not lower their fares or hurt competitor airlines, as some have

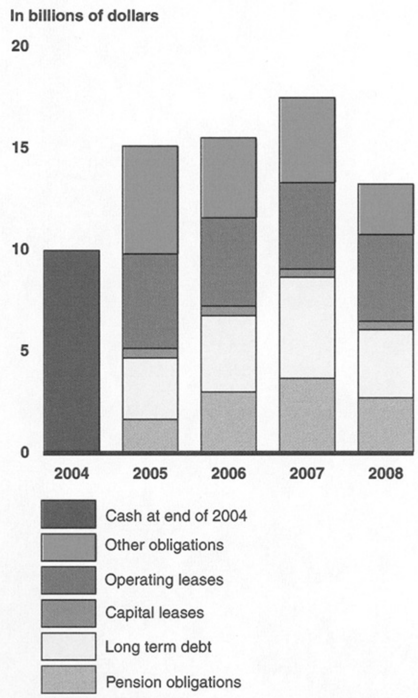
contended. A 1995 study found that an airline typically reduced its fares somewhat before entering bankruptcy. However, the study found that other airlines did not lower their fares in response and, more importantly, did not lose passenger traffic to their bankrupt rival and therefore were not harmed by the bankrupt airline.[10] Another study came to a similar conclusion in 2000, this time examining the operating performance of 51 bankrupt firms, including 5 airlines, and their competitors.[11] Rather than examine fares as did the 1995 study, this study examined the operating performance of bankrupt firms and their rivals. This study found that bankrupt firms' performance deteriorated prior to filing for bankruptcy and that their rivals' profits also declined during this period. However, once a firm entered bankruptcy, its rivals' profits recovered.

Legacy Airlines Face Significant Near-Term Liquidity Pressures, Including $10.4 Billion in Pensions Contributions Over the Next 4 Years

Under current law, legacy airlines' pension funding requirements are estimated to be a minimum of $10.4 billion from 2005 through 2008.[12] These estimates assume the expiration of the Pension Funding Equity Act (PFEA) at the end of this year.[13] The PFEA permitted airlines to defer the majority of their deficit reduction contributions in 2004 and 2005; if this legislation is allowed to expire it would mean that payments due from legacy airlines will significantly increase in 2006. According to PBGC data, legacy airlines are estimated to owe a minimum of $1.5 billion this year, rising to nearly $2.9 billion in 2006, $3.5 billion in 2007, and $2.6 billion in 2008. In contrast, low-cost airlines have eschewed defined benefit pension plans and instead use defined-contribution (401k-type) plans.

However, pension funding obligations are only part of the sizeable amount of debt that carriers face over the near term. The size of legacy airlines' future fixed obligations, including pensions, relative to their financial position suggests they will have trouble meeting their various financial obligations. Fixed airline obligations (including pensions, long-term debt, and capital and operating leases) in each year from 2005 through 2008 are substantial. Legacy airlines carried cash balances of just under $10 billion going into 2005 (see figure 7) and have used cash to fund their operational losses. These airlines fixed obligations are estimated to be over $15 billion in both 2005 and 2006, over $17 billion in 2007, and about $13 billion in 2008. While cash from operations can help fund some of these obligations, continued losses and the size of these obligations put these airlines in a sizable liquidity bind. Fixed obligations in 2008 and beyond will likely increase as payments due in 2006 and 2007 may be pushed out and new obligations are assumed.

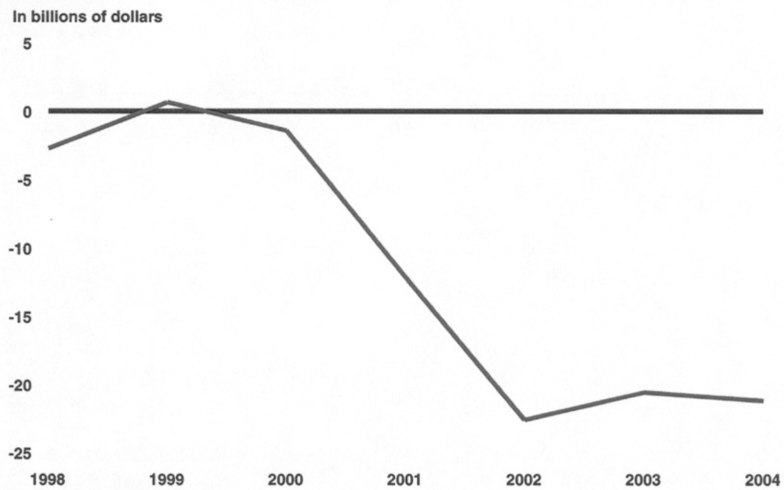
Figure 7: Comparison of Legacy Airline Year-end 2004 Cash Balances with Fixed Obligations, 2005-2008



Source: PBGC and SEC filings.

The enormity of legacy airlines' future pension funding requirements is attributable to the size of the pension shortfall that has developed since 2000. As recently as 1999, airline pensions were overfunded by $700 million based on Security and Exchange Commission (SEC) filings; by the end of 2004, legacy airlines reported a deficit of $21 billion (see figure 8), despite the termination of the US Airways pilots plan in 2003. Since these filings, the total underfunding has declined to approximately $13.7 billion, due in part to the termination of the United Airline plans, and the remaining US Airways plans.[14]

Figure 8: Funded Status of Legacy Airline Defined Benefit Plans, 1998-2004



Source: GAO analysis of SEC filings.

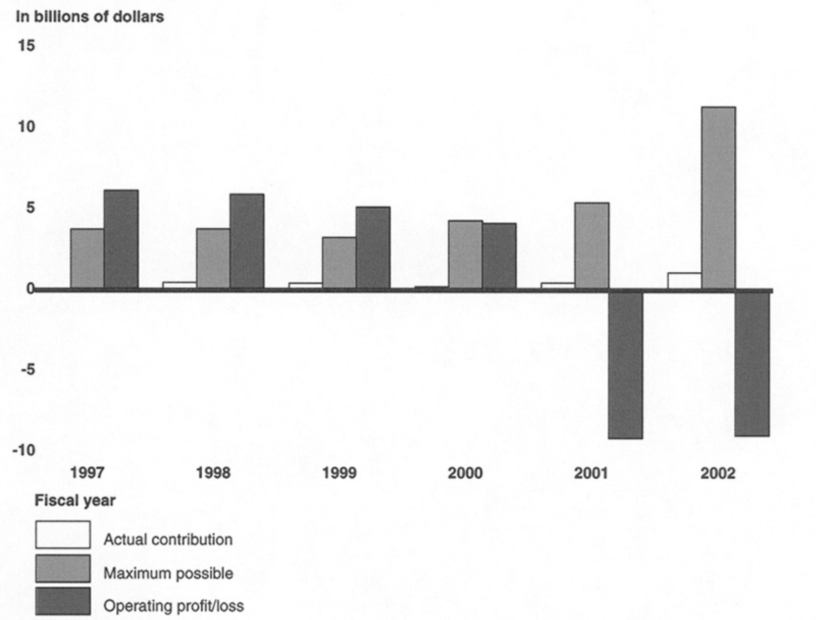
Note: The termination of the United Airlines and remaining US Airways defined benefit pension plans in 2005 reduced the total shortfall to approximately $13.7 billion, based on 2004 year-end data.

The extent of underfunding varies significantly by airline. At the end of 2004, prior to terminating its pension plans, United reported underfunding of $6.4 billion, which represented over 40 percent of United's total operating revenues in 2004. In contrast, Alaska reported pension underfunding of $303 million at the end of 2004, or 13.5 percent of its operating revenues. Since United terminated its pensions, Delta and Northwest now appear to have the most significant pension funding deficits—over $5 billion and nearly $4 billion respectively—which represent about 35 percent of 2004 operating revenues, at each airline.

The growth of pension underfunding is attributable to 3 factors:

- *Assets losses and low interest rates.* Airline pension asset values dropped nearly 20 percent from 2001 through 2004 along with the decline in the stock market, while future obligations have steadily increased due to declines in the interest rates used to calculate the liabilities of plans.
- *Management and labor union decisions.* Pension plans have been funded far less than they could have on a tax-deductible basis. PBGC examined 101 cases of airline pension contributions from 1997 through 2002, and found that while the maximum deductible contribution was made in 10 cases, no cash contributions were made in 49 cases where they could have contributed.[15] When airlines did make tax deductible contributions, it was often far less than the maximum permitted. For example, the airlines examined could have contributed a total of $4.2 billion on a tax-deductible basis in 2000 alone, but only contributed about $136 million despite recording profits of $4.1 billion (see figure 9).[16] In addition, management and labor have sometimes agreed to salary and benefit increases beyond what could reasonably be afforded. For example, in the spring of 2002, United's management and mechanics reached a new labor agreement that increased the mechanics' pension benefit by 45 percent, but the airline declared bankruptcy the following December.

Figure 9: Comparison of Legacy Airline Pension Maximum and Actual Contributions and Operating Profits, 1997-2002



Source: PBGC and DOT.

- *Pension funding rules are flawed.* Existing laws and regulations governing pension funding and premiums have also contributed to the underfunding of defined benefit pension plans. As a result, financially weak plan sponsors, acting within the law, have not only been able to avoid contributions to their plans, but also increase plan liabilities that are at least partially insured by PBGC. Under current law, reported measures of plan funding have likely overstated the funding levels of pension plans, thereby reducing minimum contribution thresholds for plan sponsors. And when plan sponsors were required to make additional contributions, they often substituted "account credits" for cash contributions, even as the market value of plan assets may have been in decline. Furthermore, the funding rule mechanisms that were designed to improve the condition of poorly funded plans were ineffective.[17] Other lawful plan provisions and amendments, such as lump sum distributions and unfunded benefit increases may also have contributed to deterioration in the funding of certain plans. Finally, the premium structure in PBGC's single-employer pension insurance program does not encourage better plan funding.

The cost to PBGC and participants of defined benefit pension terminations has grown in recent years as the level of pension underfunding has deepened. When Eastern Airlines defaulted on its pension obligations of nearly $1.7 billion in 1991, for example, claims against the insurance program totaled $530 million in underfunded pensions and participants lost $112 million. By comparison, the US Airways and United pension terminations cost PBGC $9.6 billion in combined claims against the insurance program and reduced participants' benefits by $5.2 billion (see table 2).

Table 2: Airline Pension Termination Information

(in millions of dollars)

Airline	Fiscal year of plan terminations	Benefit liability	PBGC liability	Net claim on PBGC	Estimated participant losses
Eastern	1991	1,686	1,574	530	112
PanAm	1991, 1992	1,267	1,212	753	55
TWA	2001	1,729	1,684	668	45
US Airways	2003, 2005	7,900	5,926	3,026	1,974
United	2005	16,800	13,600	6,600	3,200

Source: PBGC.
Note: "Benefit liability" is the value of the benefits promised to participants and their beneficiaries immediately prior to plan termination. "PBGC liability" is the amount that PBGC pays after statutory guarantee limits are imposed. "Net claim on PBGC" is the difference between the PBGC liability and the assets PBGC obtains from the plan. "Estimated participant losses," the difference between the Benefit Liability and the PBGC liability, equals the value of the benefits that plan participants and their beneficiaries lose when PBGC takes over a plan.

In recent pension terminations, because of statutory limits, active- and high-salaried employees generally lost more of their promised benefits compared to retirees and low-salaried employees. For example, PBGC generally does not guarantee benefits above a certain amount, currently $45,614 annually per participant at age 65.[18] For participants who retire before 65, the benefits guaranteed are even less; participants that retire at age 60 are currently limited to $29,649. Commercial pilots often end up with substantial benefit cuts when their plans are terminated, because they generally have high benefit amounts, and are also required by FAA to retire at age 60. Far fewer non-pilot retirees are affected by the maximum payout limits. For example, at US Airways fewer than 5 percent of retired mechanics and attendants faced benefit cuts as a result of the pension termination. Tables 3 and 4 summarize the expected cuts in benefits for different groups of United's active and retired employees.

Table 3: United Airlines Active Employee Pension Termination Benefit Cuts

Plan	Active employees in plan	Active employees with benefit cuts	Extent of benefit cut		
			1% to < 25%	≥ 25% to < 50%	≥ 50%
Management, Administrative, and Public Contact Employees	20,784	19,231	1,696	15,885	1,650
Ground Employees	16,062	16,062	11,448	3,441	1,173
Flight Attendants	15,024	11,109	1,305	7,067	2,737
Pilots	7,360	7,270	3,927	2,039	1,304

Source: PBGC.
Note: Calculation estimates made with 1/1/2005 seriatim data.

Table 4: United Airlines Retiree Pension Termination Benefit Cuts:

Plan	Retirees in plan	Retirees with benefit cuts	Extent of benefit cut		
			≥ 1% to < 25%	≥ 25% to < 50%	≥ 50%
Management, Administrative, and Public Contact Employees	11,360	2,996	2,816	104	76
Ground Employees	12,676	4,961	4,810	121	30
Flight Attendants	5,108	29	27	1	1
Pilots	6,087	3,041	1,902	975	164

Source: PBGC.
Note: Calculation estimates made with 1/1/2005 seriatim data:

It is important to emphasize that relieving legacy airlines of their defined benefit funding costs will help alleviate immediate liquidity pressures, but does not fix their underlying cost structure problems, which are much greater. Pension costs, while substantial, are only a small portion of legacy airlines' overall costs. As noted previously in figure 3, the cost of legacy airlines' defined benefit plans accounted for a 0.4 cent, or 15 percent difference between legacy and low-cost airline unit costs. The remaining 85 percent of the unit cost differential between legacy and low-cost

carriers is attributable to factors other than defined benefits pension plans. Moreover, even if legacy airlines terminated their defined benefit plans it would not fully eliminate this portion of the unit cost differential because, according to labor officials we interviewed, other plans would replace them.

Concluding Observations

While the airline industry was deregulated 27 years ago, the full effect on the airline industry's structure is only now becoming evident. Dramatic changes in the level and nature of demand for air travel combined with an equally dramatic evolution in how airlines meet that demand have forced a drastic restructuring in the competitive structure of the industry. Excess capacity in the airline industry since 2000 has greatly diminished airlines' pricing power. Profitability, therefore, depends on which airlines can most effectively compete on cost. This development has allowed inroads for low-cost airlines and forced wrenching change upon legacy airlines that had long competed based on a high-cost business model.

The historically high number of airline bankruptcies and liquidations is a reflection of the industry's inherent instability. However, this should not be confused with causing the industry's instability. There is no clear evidence that bankruptcy has contributed to the industry's economic ills, including overcapacity and underpricing, and there is some evidence to the contrary. Equally telling is how few airlines that have filed for bankruptcy protection are still doing business. Clearly, bankruptcy has not afforded these companies a special advantage.

Bankruptcy has become a means by which some legacy airlines are seeking to shed their costs and become more competitive. However, the termination of pension obligations by United Airlines and US Airways has had substantial and wide-spread effects on the PBGC and thousands of airline employees, retirees, and other beneficiaries. Liquidity problems, including $10.4 billion in near term pension contributions, may force additional legacy airlines to follow suit. Some airlines are seeking legislation to allow more time to fund their pensions. If their plans are frozen so that future liabilities do not continue to grow, allowing an extended payback period may reduce the likelihood that these airlines will file for bankruptcy and terminate their pensions in the coming year. However, unless these airlines can reform their overall cost structures and become more competitive with low-cost competition; this will be only a temporary reprieve.

This concludes my statement. I would be pleased to respond to any questions that you or other Members of the Subcommittee may have at this time.*

ENDNOTES

[1] While there is variation among airlines in regards to the size and financial condition, we adhere to a construct adopted by industry analysts to group large passenger airlines into one of two groups—legacy and low-cost. Legacy airlines (Alaska, American, Continental, Delta, Northwest, United, and US Airways) predate airline deregulation of 1978 and have adopted a hub-and-spoke network model that can be more expensive to operate than a simple point-to-point service model. Low cost airlines (AirTran, America West, ATA, Frontier, JetBlue, Southwest, and Spirit) have generally entered the market since 1978, are smaller, and generally employ a less costly point-to-point service model. The 7 low-cost airlines have consistently maintained lower unit costs than the 7 legacy airlines.

[2] Two other smaller carriers—ATA Airlines and Aloha—are also in bankruptcy protection. Hawaiian Airlines just emerged from bankruptcy protection earlier this month.

[3] The Pension Benefit Guaranty Corporation's (PBGC) single-employer insurance program is a Federal program that insures certain benefits of the more than 34 million worker, retiree, and separated vested participants of over 29,000 private-sector defined-benefit pension plans. Defined-benefit pension plans promise a benefit that is generally based on an employee's salary and years of service, with the employer being responsible to fund the benefit, invest and manage plan assets, and bear the investment risk. A single-employer plan is one that is established and maintained by only one employer. It may be established unilaterally by the sponsor, or through a collective bargaining agreement.

[4] U.S. Government Accountability Office, *COMMERCIAL AVIATION: Legacy Airlines Must Further Reduce Costs to Restore Profitability* (GAO–04–836) August, 2004.

[5] We found all relevant data for assessing the financial condition of the airline industry, analyses of the effects of bankruptcy on the industry as a whole and six case

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*Individuals making key contributions to this testimony include Paul Aussendorf, Anne Dilger, Steve Martin, Richard Swayze, and Pamela Vines.

studies of hub markets affected by airline bankruptcy or service withdrawals, interviews with industry and subject area experts, and analyses of SEC and PBGC data to be sufficiently reliable for our purposes.

[6] Legacy airlines' fuel costs as a percentage of total operating costs doubled from 11.5 percent during the 4th quarter of 1998 to 22.9 percent during the 4th quarter of 2004. Fuel costs for these airlines were $5 billion higher in 2004 than in 2003—an amount roughly equal to their net operating losses.

[7] Airlines may file for two types of bankruptcy. Chapter 7 of the bankruptcy code governs the liquidation of the debtor's estate by appointed trustees of the court. Chapter 11 of the code governs business reorganizations and allows, among other things, companies to reject collective bargaining agreements and renegotiate contracts and leases with creditors with the approval of the court. Companies may also convert from a Chapter 11 reorganization into a Chapter 7 liquidation or may liquidate within Chapter 11.

[8] The National Commission to Ensure a Strong Competitive Airline Industry, *Change, Challenge, and Competition,* A Report to the President and Congress, August 1993.

[9] Conversely, consolidation within the industry may help remove some capacity. The pending merger between America West and US Airways contemplates an airline with approximately 10 percent less total capacity than what the two carriers now operate independently. The U.S. Federal Government will own a significant stake in the merged company: the Air Transportation Stabilization Board will own 11.2 percent of the company, and the PBGC will own at least 5 percent.

[10] *Do Airlines In Chapter 11 Harm Their Rivals?: Bankruptcy and Pricing Behavior in U.S. Airline Markets,* National Bureau of Economic Research Working Paper 5047, Severin Borenstein and Nancy L. Rose, February 1995.

[11] *The Effect of Bankruptcy Filings on Rivals' Operating Performance: Evidence From 51 Large Bankruptcies,* Robert E. Kennedy, International Journal of the Economics of Business; Feb. 2000; pp. 5–25.

[12] These estimates include only legacy airlines that continue to sponsor defined benefit pension plans and reported their estimated pension obligations to PBGC. Pension law provisions prohibit publicly identifying the airlines that have reported this information.

[13] Pension Funding Equity Act of 2004 (Pub. L. 108–218, April 10, 2004). The PFEA also changed the interest rate used to calculate future liability from the 30-year Treasury bond to a corporate bond rate, which effectively reduces future liabilities.

[14] SEC data and PBGC data on the funded status of plans can differ because they serve different purposes and provide different information. The PBGC report focuses, in part, on the funding needs of each pension plan. In contrast, corporate financial statements show the aggregate effect of all of a company's pension plans on its overall financial position and performance. The two sources may also differ in the rates assumed for investment returns on pension assets and in how these rates are used. As a result, the information available from the two sources can appear to be inconsistent. PBGC data also are not timely. For more information, see GAO, *Private Pensions: Publicly Available Reports Provide Useful but Limited Information on Plans' Financial Condition* (GAO–04–395) March 31, 2004.

[15] These 101 cases covered 18 pension plans sponsored by 5 airlines.

[16] Pension funding rules permit sponsors to choose the interest rate used to determine the maximum deductible pension contribution permitted from an interest rate "corridor"—a limited range of interest rates. In calculating the maximum deductible contribution, a higher interest rate produces a lower deductible contribution limit. The maximum deductible contributions referred to in this paragraph and figure 9 are calculated using the lowest interest rate permissible from the interest rate corridor.

[17] For further information, see U.S. Government Accountability Office, *PRIVATE PENSIONS: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules,* GAO–05–294, (Washington, D.C.: May 31, 2005).

[18] This guarantee level applies to plans that terminate in 2005. The amount guaranteed is adjusted: (1) actuarially for the participant's age when PBGC first begins paying benefits and (2) if benefits are not paid as a single-life annuity. Because of the way the Employee Retirement and Income Security Act of 1974 (ERISA), as amended, allocates plan assets to participants, certain participants can receive more than the PBGC guaranteed amount.

Senator BURNS. Thank you. Now we have Mr. Jim May, President and CEO of the Air Transport Association here. Thank you for coming.

STATEMENT OF JAMES C. MAY, PRESIDENT/CEO, AIR TRANSPORT ASSOCIATION OF AMERICA, INC.

Mr. MAY. Thank you, Mr. Chairman, and thank you, Co–Chairman Inouye, for allowing us to appear today. My starting point discussed at length in our written comments is the financial state of the industry. And unquestionably, as we all have acknowledged, the last few years have been our most difficult. 2001 to 2004 aggregate net losses were $32.3 billion, and it has left our airlines deeply in debt, which is a related issue that we need to be sensitive to. At the end of 2004, the industry's net was more than $81 billion with a debt-to-capital ratio of 110 percent.

Now, my comments will focus on why a financially stable airline industry is important to this country, the key factors inhibiting industry financial stability, and some of the things that we think need to happen in order to regain, not just stability, but sustainable growth in profit. Simply put, a stable industry, including both the passenger and cargo airlines, is critical to a healthy and robust U.S. economy. Pulitzer prize-winning economist Dan Gergen released his latest book last week and said as follows: "every day the airline industry propels the economic takeoff from our nation. It is the great enabler, leading together all corners of the country, facilitating the movement of people and goods that is the backbone of economic growth. And it also firmly imbeds us in that awesome process of globalization that is defining the 21st Century."

Now, the alternative to this vision is a wounded industry unable to provide the air transport demanded by the shipping and traveling public and unable to provide a return to shareholders. It is not an acceptable alternative. Over the past 4 years, airlines have engaged in dramatic efforts to reduce those costs that are within our control, and I'd like to stress that point. Reduce those costs that are within our control. Out of adversity, we have transformed ourselves in many ways, capital spending, $9.5 billion, a 62 percent reduction from year 2000 levels. Pay and work rule changes were hammered out to achieve a 20 percent productivity improvement. Operating costs have been trimmed, even to the point of removing pillows and pretzels, and operations have been streamlined to reduce fuel burn, and we have improved overall system efficiency, closed up, eliminated routes, and taken down frequencies.

Now, in this difficult and painful process, as my good friend Mr. Roach knows, 135,000 dedicated men and women have lost their jobs. That's an 18 percent reduction from August of 2001.

Unfortunately, the benefits of these changes that have been made which brought the cost structures of the older network carriers much closer to those of their younger low-cost brethren, and I have a small disagreement with the first witness here on that point because I think we have reduced and narrowed the cost differences with the low prices have been more than offset by costs the airlines can't control; fuel, taxes, and fees. Unfunded mandates, in particular those unfunded mandates caused by security imperatives. And with oil trading at an all-time high and the price of jet

fuel skyrocketing, and my colleague to my left will talk about the difference between the crack spread, which is the difference between what oil is trading, and what we are actually paying for jet fuel for airplanes. This industry cannot achieve a sustained profit sufficient to repair the damage of the last 4 years.

We are looking at a rolling 12-month forecast for the price of oil to stay above $60 a barrel. Now, in short, those high fuel prices are overwhelming our ability to achieve profitability. It's noted that X fuel minus the cost of the increased fuel, a number of our carriers would have had the most profitable second quarters in their history, so it's those external costs.

We are delighted at reports of improved revenues and system yields at some of the carriers, and certainly the possibility that one or two airlines might even report some small profits for the second quarter of this year, but domestic yields in particular are still weak and it remains to be seen if these revenue improvements will carry over into the fall and the winter quarters. At current oil prices, we predict a net industry loss for the year 2005 in excess of $5 billion.

Now, our industry recovery is also inhibited by the many taxes and fees it must contend with, and I think this is an area where the government and this Congress could help more by doing less. Airlines will pay more than $15 billion in taxes and fees in 2005, resulting in the highest tax rate of any industry, according to one respected Wall Street analyst. Even a modest reduction of the tax burden will help restore the industry to financial health, facilitate jobs and economic growth and it's not a new or revolutionary idea that I'm suggesting to you. More than 10 years ago, the national Commission to ensure a strong, competitive airline industry, the so-called Nanetta Commission, recommended, "the industry be released of its unfair tax burden". Now, that was 10 years ago. Looking forward, I think there is a tremendous opportunity for positive action approaches. Together, we have a chance to reshape the FAA's air traffic control system to meet current and future needs, and reduce our costs in that system. Our antiquated air traffic control system based on ground-based radars should be retired to the Smithsonian, where it can be admired as one of the marvels of 1950s technology. I think we need to proceed swiftly and purposely with the creation of the new satellite GPS-based system, one that will reduce costs, relieve congestion, authorize traffic flow, and open up air space for future growth. If the industry is to achieve sustained profitability, it is imperative that Congress and the FAA do three things.

First, establish an ATC funding mechanism that distributes costs equitably among all system users, creating a reliable funding stream that's bonding and flexible enough to accommodate changes in the way the system is used. We need to have the FAA operate the ATC more efficiently, including consolidating unnecessary facilities, decommissioning obsolete facilities and equipment, and rationalizing the workforce.

There are 14,000 different communications entities within the FAA as part of the air traffic control system. That is unsafe.

Finally, the FAA must develop and implement procedures and technologies that will increase current system capacity and efficiency as quickly as possible, and that will enable future growth.

Mr. Chairman, with the health of the airports or the re-authorization of the airports, and not only this industry and this committee, I think it's time for an exercise in very difficult choices. If together we do it right, we are going to lay the foundation for a bright future for the airlines and the economy that we enable. We are going to be attacking those costs that we can't attack without your help, and we are going to continue to attack the costs that we have some control over in our own systems. Thank you for the opportunity to appear.

[The prepared statement of Mr. May follows:]

PREPARED STATEMENT OF JAMES C. MAY, PRESIDENT/CEO, AIR TRANSPORT ASSOCIATION OF AMERICA, INC.

The Air Transport Association of America, Inc. (ATA) appreciates the opportunity to comment on the financial health of the U.S. airline industry. Unfortunately, the overall financial picture remains grim because the price of oil continues to surge. Increasing oil and fuel prices have offset the recent modest improvement some carriers have experienced on the revenue front. We would like nothing better than to dwell on what little good news there is, but to do so would be misleading. The truth is, the financial health of the U.S. airline industry remains poor, and the industry still has a long way to go before it can be declared healthy again.

The Current Industry Snapshot

The U.S. airline industry in 2005 remains in critical condition and is poised to add over $6 billion to the $32.3 billion in losses incurred between 2001 and 2004. The current state of the industry is the result of factors and events that have altered industry fundamentals. The fact that industry fundamentals have changed distinguishes this down-cycle from all prior cycles.

One fundamental that has changed is that spending on air travel has dropped to 0.7 percent of U.S. GDP from its historical level of between 0.9 and 1.0 percent of GDP. This means that on a proportional basis Americans today are spending considerably less on flying than in previous years—amounting to roughly $29.5 billion annually. If spending had slipped to just 0.8 percent of GDP, the industry's financial condition would be markedly different.

All airlines have been affected by these fundamental changes, and all airlines have responded in kind by sharply reducing or limiting controllable costs, paring back capital spending, revising long-standing collective bargaining agreements, streamlining operations, and improving productivity. While there may be pockets of such costs still to be addressed at some airlines, no one should forget that more than 100,000 employees—one out of six—have lost their jobs since 9/11. There is no question that the airline industry has drastically reduced controllable costs.

Notwithstanding these Herculean efforts, industry profitability remains elusive, and the timing of the industry's return to profitability is unclear. While recently there have been some hoped-for signs of recovery, those signs have been inconsistent and the industry's financial health remains dependent on many factors outside of its control: a strong economy, effective security worldwide, reduced or stable oil prices, and an air traffic control system that will accommodate, safely and efficiently, the growth demanded by the American public.

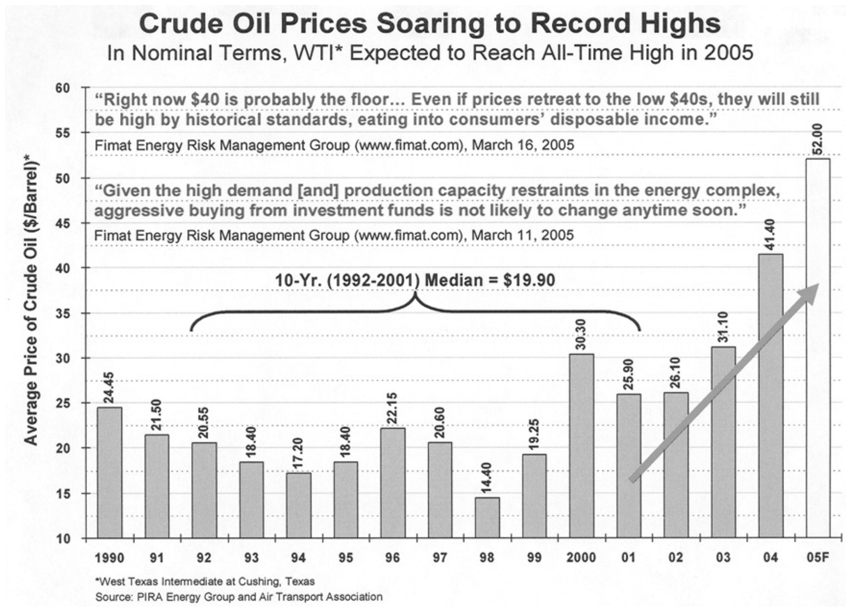
Notwithstanding these financial challenges, it should not be overlooked that airline safety has remained rock solid. "Safety first" remains the core industry value. In 2004, the National Transportation Safety Board (NTSB) reported only one fatal accident in over 10 million scheduled departures. In the three years 2002–2004, there were just three fatal accidents in 31 million scheduled departures. In those three years, airlines providing Part 121 scheduled operations carried nearly 1.9 billion passengers. Without question, scheduled air service is incredibly safe.

The events and factors that knocked the U.S. airline industry into a condition requiring the equivalent of intensive care are well known and need not be repeated here. However, there are certain factors that warrant further attention because they continue to adversely affect the industry's financial condition. The common thread running through these factors is that they are beyond the direct control of the airlines.

1. The Cost of Fuel Forecloses Financial Recovery

The simple truth is that, but for the high price of fuel, the U.S. airline industry today could earn a small profit. As industry fundamentals go, the price of fuel is

the most significant force affecting the industry today. For the ten year period 1992–2001, the median price of crude oil was $19.90. Even in 2001 and 2002, crude oil was relatively stable in the $25–$26 range. In 2003, the average price jumped to over $31 a barrel, and in 2004 the average price jumped again to more than $41 a barrel. Today, crude is over $60 per barrel, and the 2005 price is expected to average at least $52 per barrel. In fact, the twelve month rolling forecast currently has crude oil at over $60 per barrel through July 2006.[1] In essence, oil prices have nearly doubled in two years, and when compared to the 1992–2001 median average they have tripled.



Jet Fuel prices have mirrored the price of crude oil, and 2005 prices are expected to surpass the 2004 record prices. The true cost impact on the airlines of this unprecedented increase is staggering and virtually defies comprehension. As the charts below show, the industry's 2004 jet fuel expense would have been $11.8 billion at the average price paid during the 1992–2001 period, compared to the actual $21.4 billion paid in 2004. We now expect the industry fuel bill to rise another $6.7 billion in 2005, to more than $28 billion, assuming fuel consumption remains unchanged. At some airlines, fuel costs now exceed personnel costs as the number one expense category.[2]

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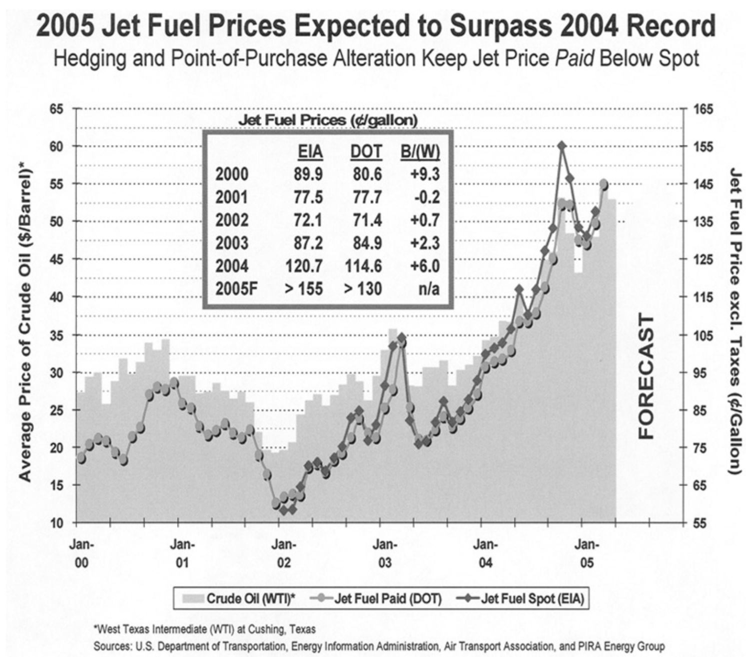
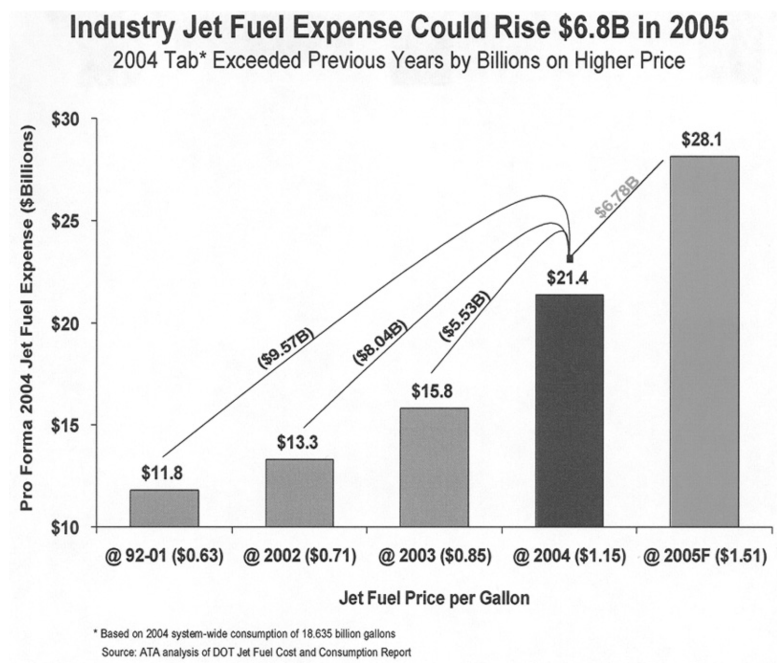
[1] Fimat, Energy Overview (July 8, 2005), found at *http://research.fimat.com/dominoapps/fimatres.nsf/C5934649E5F8BDB886257038004DFC75/$FILE/tcc1__new.pdf.*

[2] *Jet Fuel Expense Surges Past Personnel Costs,* MSNBC.com (July 11, 2005).





Given the vigorous competitive climate of the industry, discussed below, airlines have not been able to include in ticket prices the increased cost of fuel. To cover the jet fuel price increases from 2003 to 2004, for example, passengers would have had to pay on average an additional $21 per ticket. Yet ticket prices during this period fell because of intense competition. The industry would be in a much dif-

ferent, healthier condition had the airlines been able to pass on their actual fuel costs.

An operating fundamental of the industry is that airplanes run only on jet fuel. There is no alternative. The related economic fundamental is that the dramatic change in the price of fuel now appears to be permanent. The days of $20–$35 per barrel oil are over. We will be fortunate if the price slips back to $40–$50 per barrel. Given the worldwide demand for oil products and finite refining capacity, particularly in the U.S., some analysts predict even higher prices. A recent Goldman Sachs report suggests prices may rise as high as $105 per barrel.[3] Moreover, the market is highly susceptible to any possible supply disruption, as the price spike in anticipation of tropical storm Arlene in early June illustrated.[4] On June 17, oil surged to a then-all time high—exceeding $58 per barrel—over concerns about both supply and refining capacity.[5] Last week, oil prices eclipsed $60 per barrel, continuing an apparently inexorable climb upward.

The increase in the price of fuel has been rapid and dramatic. Because of the complexity of market forces at play in the airline industry, this fundamental economic change strongly affects the cost side of the ledger, increasing the revenues needed for profitability. As a result, complete recovery—defined by a return to profitability—remains foreclosed. When the industry might achieve profitability remains uncertain. As one market analyst observed recently:

> On a non-fuel basis, operating profitability . . . is as good as it was in the late 1990s. While these facts are exciting . . ., they may also be totally moot if oil prices do not return to [historical norms] . . . *Unfortunately, high fuel prices are consuming what would otherwise be an upcycle for the industry.*[6]

2. Taxes and Fees Weigh Down the Industry

The industry continues to be weighed down by excessive taxes and fees imposed on airlines and their customers. The negative economic impact of these taxes and fees is a drag on the industry and hampers its ability to return to profitability. This is one area in which the government could help more by doing less. As one analyst has noted:

> [T]he airline industry pays the highest Federal tax rate of any industry as it continues to lose massive amounts of money through user and security taxes that amount to an estimated 10 percent of revenues . . . in reality, in a highly competitive, weak revenue environment, the taxes are paid for by the airlines . . .
>
> Ray Neidl, Speech at the National Air Service Conference (January 24, 2005).

The tax and fee burden on airlines operating in, to, and from the U.S. exceeded $14 billion in FY 2004 and are expected to exceed $15 billion in 2005. This tax burden distorts the normal functioning of market forces and fundamentally depresses the industry. Nonetheless, the appetite for taxing the industry remains strong. Since 1988, the average tax on a $200 domestic round-trip ticket has increased 250 percent, while average domestic yields have actually declined 3 percent. This is so despite the 1993 recommendation, made by the National Commission to Ensure a Strong Competitive Airline Industry, to relieve the industry of its "unfair tax burden." [7]

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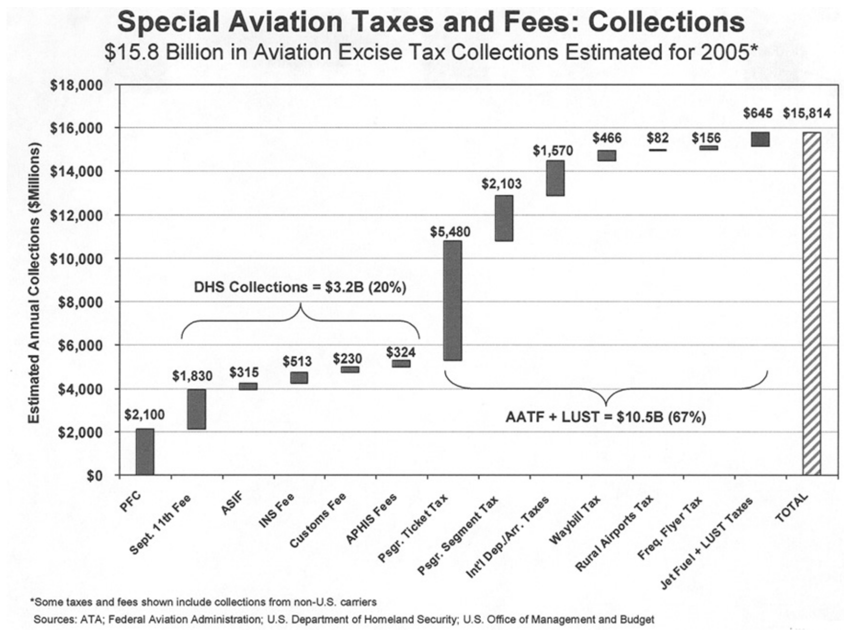
[3] Goldman Sachs, *"U.S. Energy: Oil—Super Spike Period May be Upon Us,"* March 30, 2005.

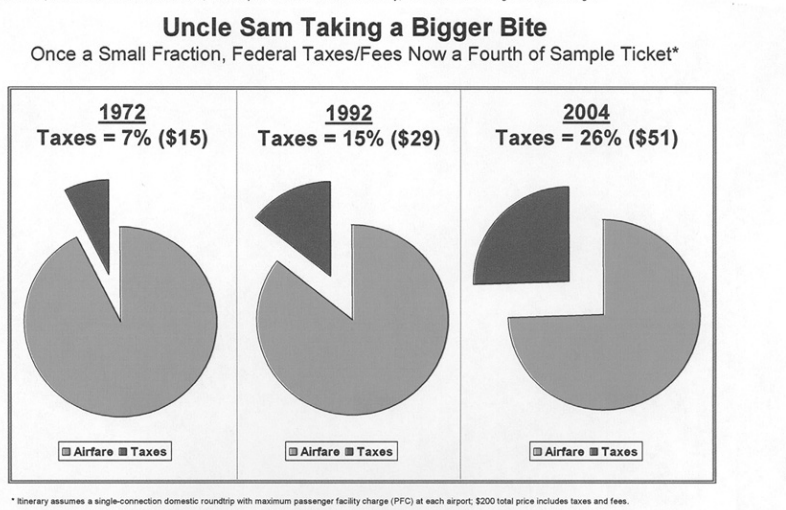
[4] A June 10, 2005 report issued by the Energy Risk Management Group of Fimat, for example, stated: "The response to Arlene's approach shows with brutal clarity how sensitive the market is to any possible supply disruption. With the potential impact on production and transportation at least part of the rally was justified. . . . The storm headlines surprised and prompted waves of short covering and possibly a moderate amount of fresh speculative buying, as well." *http://research.fimat.com/dominoapps/fimatres.nsf/0B9A9C6DBB71AF2E8625701C004AA162/$FILE/tcc1__new.pdf.*

[5] "Oil Prices Surge All-time High," MSNBC, June 17, 2005, at *http://www.msnbc.msn.com/id/5612507.*

[6] Gary Chase, Lehman Brothers, "Industry Update," March 15, 2005.

[7] "Tax policies often have had a major and adverse effect on the industry. Although the Commission concluded that tax changes alone will not restore the industry to profitability, we believe there are several tax provisions that impede the ability of the industry to return to financial health. We believe those provisions violate reasonable principles of common sense and good public policy and we are of the opinion changes must be made to relieve the airline industry's unfair tax burden." *Change, Challenge and Competition: A Report to the President and Congress* (August 1993), The National Commission to Ensure a Strong Competitive Airline Industry.





Aviation taxes have outpaced inflation and prices, and air transportation is taxed at a higher rate than the consumption of beer and liquor, telephone service, and most notably, bus and rail transportation, which face no Federal travel tax.

Federal Consumption Taxes and Fees High on Flyers*

Uncle Sam Taxes Low-Priced Air Travel Above Sins, Luxuries, and Other Modes

Product	Percent	Product	Percent
Plane Ticket: One-Stop ($100)[1]	44.2	Heavy Firearms / Ammunition	11.0
Plane Ticket: Non-Stop ($100)[1]	25.6	Distilled Spirits ($20)[4]	10.7
Plane Ticket: One-Stop ($200)[1]	25.6	Sport Fishing Equipment	10.0
Plane Ticket: One-Stop ($300)[1]	19.4	Pistol or Revolver	10.0
Pack of Cigarettes ($4.50)[2]	18.2	Can of Beer ($1.00)[5]	5.0
Plane Ticket: Non-Stop ($200)[1]	16.3	Luxury Vehicle (Portion > $40K)	3.0
Plane Ticket: Non-Stop ($300)[1]	13.2	Telephone Service	3.0
Arrow Components	12.4	Elec. Outboard Motors / Sonar[6]	3.0
Heavy Truck / Trailer / Tractor	12.0	Ship Ticket ($1,000)[7]	0.3
Gallon of Gasoline ($1.60)[3]	11.5	Bus Ticket	0.0
Bows	11.0	Rail Ticket	0.0

[1] Roundtrip with federally approved $4.50 PFC.
[2] Taxed at 82¢ per pack.
[3] Taxed at 18.4¢ per gallon.
[4] Taxed at $2.14 per 750-milliliter bottle.
[5] Taxed at 5¢ per can.
[6] Up to a maximum of $30.00.
[7] Taxed at $3.00 per ticket.

Note: The Federal Government also taxes the sale of tires over 40 pounds, coal, wine, vaccines, foreign-issued insurance, and selected other items.

*Analysis considers Federal taxes and fees only; does not examine the broader impact of State and local taxes, which can be especially high on alcohol and tobacco.

Sources: ATA research; Internal Revenue Service; Bureau of Alcohol, Tobacco & Firearms.

ATA appreciates this Committee's efforts to upend the Administration's proposed increase of the passenger security fee for FY 2006. As this Committee is well aware, security fees and taxes account for a significant portion of the overall tax and fee burden on the industry. In FY 2005, we estimate that the industry will provide to DHS over $3.2 billion in direct fees and taxes. Add to this the foregone revenue from certain federally mandated programs and the out-of-pocket expenses for other unfunded mandates, and very quickly the industry's annual security cost burden exceeds $4 billion. That number will only increase as more passengers fly. Yet the Administration and Members of Congress continue to discuss and debate several new mandates.[8] The airline industry cannot be expected to achieve profitability if the government continues to impose more and more taxes, fees, and unfunded mandates.

Unfortunately, the "cash cow" view of the airline industry infects the rest of the world. Several G–8 member states recently proposed a "solidarity tax" on airplane tickets as a mechanism to raise money to assist developing countries address health and welfare needs. In the view of these countries, because the airline industry facilitates globalization, and because "airline passengers seldom belong to the poorest segments of the population," a tax on air transportation is justified. The problem with this approach, of course, is that it is basically an "ends justify the means" argument and could apply to any number of issues regardless of merit.

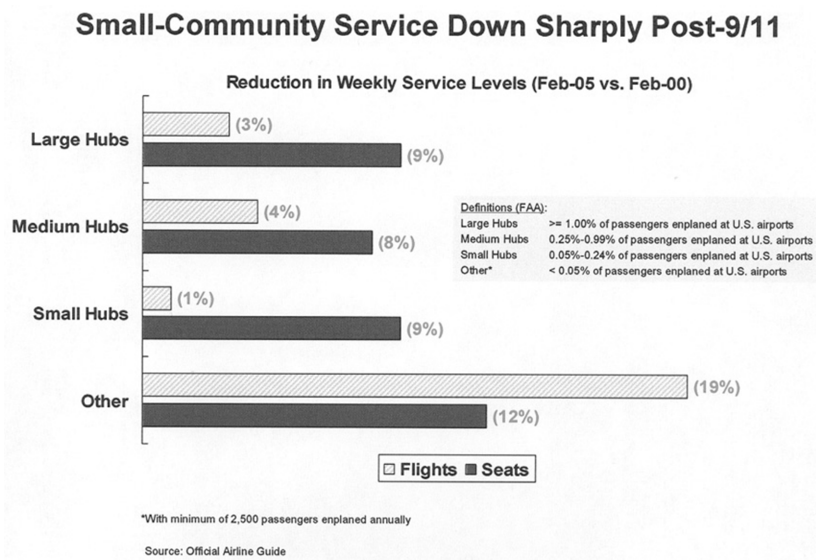
As we have said previously, it does not matter whether a tax or fee is imposed on passengers or airlines. It is the imposition of the tax that is significant,[9] with the result being that the more the government collects for air travel, the less the airlines are able to charge. As Treasury Secretary Snow has stated, "Economics tells us that anything you tax, you get less of. That's why high marginal taxes . . . are a bad idea—they kill jobs." In our view, with the right tax policy, the government can foster job creation and financial stability in the industry.

Unfortunately, excessive taxes on the airline industry are crippling a vital segment of our economy. The U.S. airline industry plays a major role in driving the

[8] These include, but are not limited to, installation and maintenance of counter-manpads devices, additional in-line EDS baggage screening equipment, increased cargo screening on passenger and all-cargo flights, implementation of the DHS Secure Flight passenger screening program, and promulgation of a rule requiring airlines to transmit passenger manifest and related passport data one hour before departure of in-bound international flights.

[9] "The statutory incidence of a tax indicates who is legally responsible for the tax. . . . Because prices may change in response to the tax, knowledge of statutory incidence tells us essentially nothing about who is really paying the tax. . . *The [economic] incidence of a unit tax is independent of whether it is levied on consumers or producers*. . . In general, the more elastic the demand curve, the less the tax borne by consumers. . . The key point to remember is that nothing about the incidence of a tax can be know without information on the relevant behavioral elasticities." *Public Finance (4th Ed.),* Harvey S. Rosen (Princeton University Department of Economics).

commerce of the United States and the growth of our national economy. An economically crippled airline industry is a drag on the national economy and ultimately will prevent it from realizing its full potential. Robust air transportation is critical to sustaining our recovery and catalyzing the next round of growth essential to our nation's economic competitiveness. As airline job losses continue to mount, and service to small- and mid-size communities is cut, it is not simply the airlines and their employees who are suffering; it is the broader economy that feels the results. Air transportation grows both the national and local economies—its absence reverses that effect.

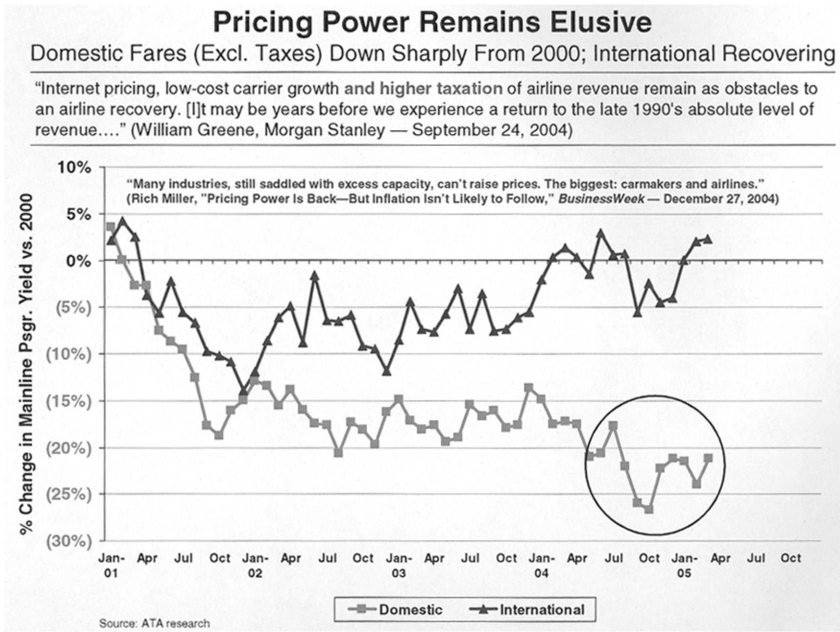


3. Pricing Power Remains Inadequate for Airlines To Recover Costs

Throughout 2004, and well into 2005, U.S. airlines were unable to raise prices. Numerous efforts failed because of the intense competitive nature of the industry and the fundamentals of supply and demand. Market analysts uniformly observed that *all* airlines lacked pricing power to pass through increased costs. For example:

> [L]egacy carriers and LCCs continue to fight strenuously for market share with a complete lack of pricing power creating an anemic revenue environment . . . Fuel . . . remains a major factor in the industry's inability to make a profit, and we remind investors that this is not the first time the airlines have been faced with tough year over year comps. However, this is the first time that carriers have not been able to pass these costs on to the consumer as evident by several failed fare increases and the declining yields.
>
> Reno Bianchi and Steven K. Burton, Citigroup Corporate Bond Research, Airline Industry Research Report, December 21, 2004.

The following chart illustrates the lack of pricing power from January 2001 through the first quarter of 2005 by tracking mainline passenger yields:



Recently, airlines have been able to maintain some price increases, and this modest success offers a glimmer of hope for the future. At this point, however, it remains only a glimmer. During the second week of June, for example, multiple attempts at fare increases failed under competitive pressures.[10] Passengers remain extremely price sensitive, and price competition among all airlines is robust.[11] Consequently, even low-cost airlines are not sanguine about increasing revenue through fare hikes, as confirmed by Independence Air's Eric Nordling: "The flying public is highly elastic; it is very sensitive to price." [12]

The simple truth is that if the airlines could raise their prices to cover fuel costs and the many taxes and fees they pay, they would have done so by now. They haven't, and basic marketplace principles—competition and elasticity—are continuing to prevent them from doing so. It remains to be seen when, if ever, pricing power returns to the point where profitability can be restored notwithstanding increasing fuel prices.

4. Expanding the Air Traffic Control System's Capacity and Enhancing ATC Productivity Is Critical to the Financial Health of the Industry

The American people want convenience and value for their money. That is why they are flying in record numbers this summer. U.S. airlines provide safe, convenient, and reliable service at a fair price.[13] Maintaining system reliability, however, is becoming increasingly difficult as airlines, responding to marketplace demands for service, add flights. The financial health of the industry—today and in the future—depends in part on the ability of the FAA's Air Traffic Control (ATC) system to provide the capacity needed to meet not only the demand for scheduled passenger and cargo operations, but also the growing appetite of the non-scheduled sector, including air taxis, business jet operations and, in the near future, Very Light Jets.[14]

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[10] "Airfare Momentum Stalls After Successive Price Hikes," *Business Travel News,* June 7, 2005; "Airline Profits Are So Close, Yet Still So Far," *New York Times,* June 12, 2005; "Northwest Pulls Fare Increase," *Aviation Daily,* June 14, 2005.

[11] "[Several airlines] raised fares on some routes, then cut them a day or two later when bookings fell . . ." "Even if they wanted to take advantage of the heavy demand for summer travel, the big airlines do not have carte blanche to raise fares, because low-fare airlines keep them from doing so." *New York Times,* June 12, 2005.

[12] *Id.*

[13] Adjusted for inflation, domestic airfares, net of taxes, have dropped 51 percent over the past 25 years.

[14] *Year One—Taking Flight: 2004 Annual Performance Report,* Federal Aviation Administration, Air Traffic Organization (March 2005) (the "ATO 2004 Annual Report"), p. 23.

Inadequate ATC system capacity will stymie airline growth and the ability of the industry to achieve and maintain financial health. That, in turn, will adversely affect the commerce of the United States and the American public. Without a dramatic change in the way our nation's airspace is managed, congestion and resulting delays will be overwhelming for consumers and businesses alike. As it is, 86.5 million ATC delay minutes were responsible for adding an estimated $6.2 billion to direct operating costs for U.S. airlines in 2004. The FAA is predicting that by the end of 2005 commercial aviation flights will have regained the peak levels of 2000.[15] Operations at en route centers actually have surpassed the number handled in 2000.[16]

Just maintaining the safety and efficiency of our air traffic system at the current level of operations is not an option. The FAA will have to increase system capacity and productivity to accommodate an estimated 25 percent increase in the volume of air traffic in the next decade.[17] In fact, the Joint Planning and Development Office is seeking to expand capacity by as much as 300 percent by 2015 to accommodate changes in aircraft size as well as the projected growth in demand.[18] ATA members support these efforts.

The alternative, measures that restrict operations such as those imposed at Chicago's O'Hare International Airport, are unacceptable. Arbitrary restrictions on operations will undermine the public benefits Congress envisioned when it deregulated the industry. Ultimately, such restrictions will add new operating costs as access to the system is rationed. Indeed, within the Administration, the notion of "market-based" solutions to allocate landing and take-off rights at certain airports is gaining currency already. These solutions could result in new fees and charges that airlines would have to pay. Realistically, given the fierce price competition within the industry, it is unlikely these new charges could be passed on to customers.

The solution lies in a modernized ATC system that uses technology and operational measures to increase capacity and enable growth. In the near term, consolidating facilities and decommissioning outdated equipment and procedures should provide help at the margins. Capacity of the current system can be increased by leveraging existing on-board technologies and creating new satellite-based routes that are more flexible than existing routes; gains can also be achieved by doing a better job keeping slower airplanes separated from faster moving airplanes. A key measure is to manage the ATC system from a national perspective instead of the current patchwork of airspace components, each managed individually. This locally-driven system creates too many opportunities for bottlenecks and inefficient use of the airspace from a total system perspective. Looking forward, any new system must be built on a scalable architecture that maximizes flexibility and ease of growth.

Conclusion

The U.S. airline industry remains in dire financial condition, with several airlines in Chapter 11 and other airlines facing that possibility as oil prices continue to climb. The prospects for a return to stability and profitability remain uncertain in light of factors largely out of the control of the airlines. Nevertheless, it can be said that a glimmer of hope is on the horizon. People are flying again in record numbers, and airline cost-cutting measures are having a positive impact.

Looking forward, Congress and the Administration will play a significant role in the financial health of the industry. The tax and fee burden remains excessive and should be reduced. By no means should new taxes and fees be added, no matter what the purpose. Further, when the Aviation Trust Fund comes up for reauthorization in 2007, it will be imperative that Congress support the FAA's efforts to expand ATC system capacity to permit expected industry growth. At that time, Congress should adopt a new funding formula that fairly apportions trust fund contributions among system users according to their use of the ATC system.

Senator BURNS. Thank you. Mr. Jamie Baker, Vice President, JPMorgan Securities, Incorporated, thank you for coming this morning.

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[15] ATO 2004 Annual Report, p.23.

[16] *Next Steps for the Air Traffic Organization,* Statement of the Honorable Kenneth M. Mead Before the Committee on Transportation and Infrastructure, Subcommittee on Aviation, United States House of Representatives (April 14, 2005) p. 2 (Mead Testimony), p.2.

[17] Federal Aviation Administration, *Aerospace Forecasts, Fiscal Years 2005–2016,* Table 36, X–37.

[18] Joint Planning and Development Office, Next Generation Air Transportation System Integrated Plan (December 2004), p. 8.

STATEMENT OF JAMIE N. BAKER, VICE PRESIDENT, U.S. EQUITY RESEARCH, JPMORGAN SECURITIES, INC.

Mr. BAKER. Thank you. Chairman Burns, members of the Committee, I do want to thank you for the opportunity to in fact speak here this morning. Again, my name is Jamie Baker. I'm the U.S. airline equity analyst at JPMorgan. Please do take note that the statements that I make here today don't reflect the official position of JPMorgan on these issues.

Let me start out by emphasizing that, and echoing some of the recent testimony that it is in fact fuel prices, not industry mismanagement, that can primarily explain why we have convened here today. Fuel prices are continuing to mask an underlying recovery in the airline industry, of which many are not aware, and I would suggest that with the exception of fuel, all of the relevant industry cockpit gauges, if you will, are in the green for the first time since September 11.

Ex-fuel costs for the legacy carriers have not been this low since 1997, and they are, in fact, headed lower. If you exclude one-time non-cash and focus on core costs, those that suggest future performance, then legacy carriers have in fact decreased their cost disadvantage to the low-cost carriers by nearly 50 percent. Air fares and revenues both continue to rise with no apparent negative offset on demand. U.S. capacity, while still growing is in fact growing at a slower rate than many of us feared at the beginning of this year. If in fact fuel casts were hypothetically not an issue, both American and Continental Airlines would have just enjoyed their most profitable second quarters in their corporate histories. While we are not suggesting legacy carriers can fully match the efficiency of some of the smaller, low-cost competitors, the gap between the two is clearly diminishing. But unfortunately, these carriers that I'm employed to follow, they don't fly gliders, and therefore stripping out fuel expenses is merely an analytical exercise. Despite nearly a dozen mostly successful efforts at raising air fares this year, we estimated only $7 per barrel of crude has managed to be offset leaving the effective price of that still above historic norms. As such, liquidity is expected to decline significantly.

Delta and Northwest will burn through more than $1 billion in cash this year inclusive of the capital they have raised here today, and furthermore, the industry's ability to go deeper into debt, while seemingly never exhausted, is rapidly diminishing. Since 2000, airlines have borrowed more than $27 billion. They have seen their credit ratings fall substantially, and while legacy airlines have begun turning to nontraditional sources of capital such as the hedge fund community and the manufacturers, I think the ability to further tap these resources are unlikely unless pension reform can positively impact their credit ratings.

Delta has disclosed that its projected minimum pension funding requirements under current rules will increase to $600 million in 2006, and to more than $1.5 billion by 2008. Similarly, at Northwest, they are estimating $800 million for requirements for 2006 and $1.7 billion for 2007. For this obvious reason, both Delta and Northwest are likely to seek bankruptcy protection and follow the damaging precedent set by United Airlines in terminating its defined benefit program. That is unless we are allowing for long-term

amortization period of deficits for sponsors agreeing to freeze their DB plans comes into law, and I would suggest sometime within the next 6 months or so.

These are not my analytical opinion. The broader market implies between a 55 and 59 percent one-year bankruptcy probability for Northwest and Delta. For American and Continental, arguably two better positioned carriers, the implied bankruptcy probability over the next 4 years is roughly the same. I point out that these figures have actually worsened since my colleague, Mark Streeter, testified before the House 3 weeks ago.

But legacy Chapter 11 filings, and the accompanying toll on workers, and likely service decline to smaller communities, these are not necessarily inevitable occurrences. Legacy airline management would much prefer to avoid the Chapter 11 process and instead be left alone to do what they currently are, further reducing their competitive disadvantage to the more youthful and fit, those carriers that have sprung up since deregulation.

Now, if the government sponsors the flexibility to stretch payments over a period of several years, the sponsors, they must be forced to maintain fiscal discipline in my opinion. The price to legacy carriers of potential pension reform should include at a minimum restrictions on their ability to repurchase stock, pay dividends, or offer increased defined benefits, even if funded with cash.

Members of the Committee, if the proposed pension legislation not supported by the legacy airlines does become law, I agree with the broader market that both Delta and Northwest will be forced to file bankruptcy within the next year or so. The ability of these carriers to complete their ongoing restructuring outside of the court process is almost directly tied to pension reform that does not result in onerous near-term deficit reduction contributions. With United having already sought its subsidy and therefore having set a damaging precedent, the government instead has an opportunity to allow other carriers the opportunity to make good on promises that they have already made to their employees, while further protecting taxpayers in the process. Thank you again for the opportunity to speak here this morning.

[The prepared statement of Mr. Baker follows:]

PREPARED STATEMENT OF JAMIE N. BAKER, VICE PRESIDENT, U.S. EQUITY RESEARCH, JPMORGAN SECURITIES INC.

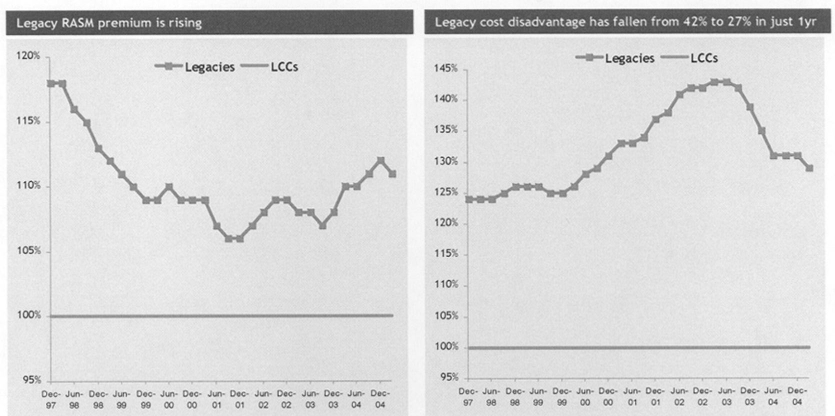
Chairman Burns and members of the Committee, thank you for inviting me to speak this morning. My name is Jamie Baker, I am the U.S. Airline equity analyst at JPMorgan. I would like to provide the Committee with an overview on the U.S. airline industry, its ongoing efforts at recovery, and how the pension issue and other factors will continue to impact this recovery. I will also focus certain comments on the remaining legacy airline defined benefit plan sponsors, AMR Corp, Continental Airlines, Delta Air Lines, and Northwest Airlines. Please note that my testimony and statements are my personal views and do not represent the official position of JPMorgan.

Fuel Is Masking Fundamental Recovery

Unfortunately for the airlines, fuel costs are masking a fundamental recovery that is well underway. Were an industry cockpit to exist, we would suggest all non-fuel gauges would be reading into the green, the first such instance since September 11, 2001. For example, ex-fuel unit costs haven't been this low since 1997, and they are expected to head lower still. Airfares and revenue are both continuing to rise, with no apparent offset on demand. Capacity, while still increasing domestically, is rising at a slower growth rate than feared, with the majority of that growth coming from

low-cost carriers. In fact, if fuel were not an issue, both American and Continental would have just concluded their most profitable second quarters in their history. While it is not our intent to suggest that legacy carriers can fully-match the efficiency and cost competitiveness of their smaller, low-cost carrier competitors, the chasm between the two sub-sectors is continuing to diminish.

Exhibit I: Legacy RASM premium rising, cost disadvantage falling



Source: Company reports and JPMorgan estimates.

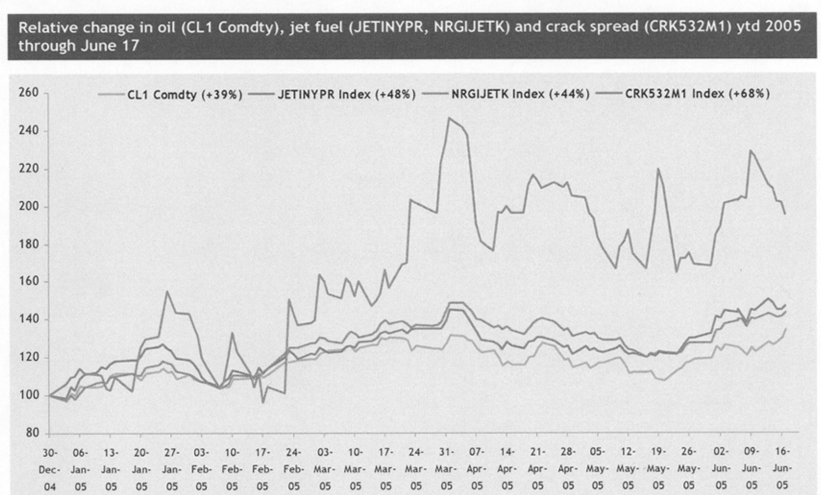
Source: Company reports and JPMorgan estimates.

But Fuel *Is* a Reality, and Legacy Airlines Don't Fly Gliders

Regrettably, stripping out fuel expense is but a mere analytical exercise. Jet kerosene prices have actually risen by a greater degree than raw crude, in part given the shortage of refinery capacity. Year-to-date, jet kerosene has risen 44 percent vs. a 39 percent increase in the price of crude.

Despite nearly a dozen, mostly successful efforts at raising fares in 2005, we estimate that merely $7 per barrel of crude agony has managed to be offset, leaving the effective price of that commodity still well above historic norms. While carriers will likely continue pressing fares higher this year and beyond, each successive fare increase is expected to generate a diminishing return, given the price-sensitivity of demand.

Exhibit II: Crack spreads have risen faster than crude prices ytd



Source: Bloomberg and JPMorgan.

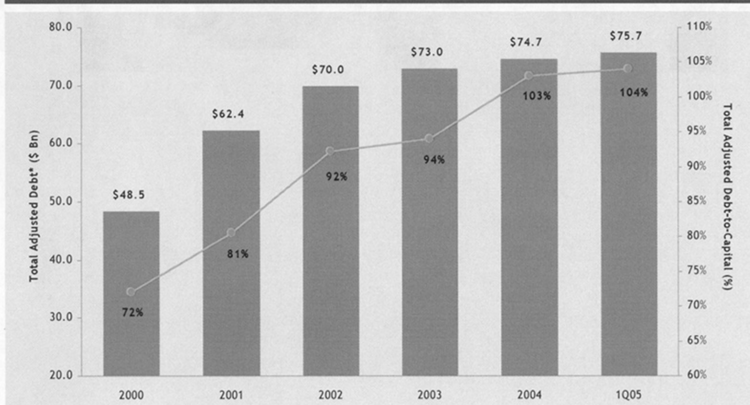
Liquidity Is Under Pressure

Legacy airline liquidity is expected to decline significantly in 2005. We estimate that Delta and Northwest will each burn through more than $1 billion this year, inclusive of the capital raised year-to-date, unless assuming cash reserves can somehow be replenished.

The industry's ability to go deeper into debt, while seemingly inexhaustible, does appear to be rapidly diminishing. Since 2000, U.S. Airlines have borrowed more than $27 billion, and have witnessed substantial declines in their credit ratings. And while legacy airlines have been turning to non-traditional lenders, such as hedge funds and the manufacturers, the ability to further tap these resources is unlikely, unless pension reform can positively impact their credit standings.

Exhibit III : Industry added >$27 billion in debt since 2000

Since 2000, total debt for majors up $27 bn; leverage up 32 points



*Total balance sheet debt plus operating leases capitalized at 8x rent (annualized for 1Q05) for AAI, ALK, AWA, AMR, CAL, DAL, JBLU, NWAC, and LUV.
Source: Company reports and JPMorgan.

Exhibit IV: Base case YE05 airline liquidity snapshot

MAINLINE ASSUMPTIONS	AMR	CAL	DAL	NWAC
RPMs (M)	135,673	72,128	106,599	76,953
yr/yr % chg	4.2%	9.7%	8.5%	5.0%
ASMs (M)	178,509	89,919	137,929	94,424
yr/yr % chg	2.6%	6.2%	6.1%	3.3%
Load Factor	76.0%	80.2%	77.3%	81.5%
yr/yr % chg	1.2%	2.6%	1.7%	1.3%
Yield	11.70¢	11.25¢	10.74¢	11.40¢
yr/yr % chg	1.3%	-0.2%	-3.0%	-0.9%
Mainline RASM	8.89¢	9.03¢	8.30¢	9.29¢
yr/yr % chg	3.0%	3.1%	-0.8%	0.7%
Mainline CASM	9.82¢	9.85¢	9.43¢	10.87¢
yr/yr % chg	1.0%	3.9%	-7.9%	5.4%
Mainline CASM ex-fuel	7.34¢	7.46¢	7.06¢	8.25¢
yr/yr % chg	-3.7%	-2.6%	-15.8%	0.9%
Fuel Cost/gal.	$1.501	$1.569	$1.474	$1.471

INCOME STATEMENT ($Mn)	AMR	CAL	DAL	NWAC
Total Revenue	$19,847	$10,804	$15,831	$11,929
yr/yr % chg	6.4%	10.9%	5.5%	5.8%
EBIT	$102	$4	($766)	($686)
yr/yr % chg	NM	NM	-48.0%	204.7%
EBITDA	$1,282	$396	$492	($158)
yr/yr % chg	10.6%	22%	303.3%	NM
EBITDAR	$1,917	$1,121	$1,203	$628
yr/yr % chg	8.4%	15%	293.8%	-40.7%
Net Income	(682)	(263)	(1,824)	(1,293)
EPS	($4.23)	($3.93)	($12.94)	($14.86)

CASH FLOW ITEMS ($Mn)	AMR	CAL	DAL	NWAC
Beginning unrestricted cash	$2,929	$1,409	$1,799	$2,459
Net Income (Loss)	($682)	($263)	($1,824)	($1,293)
+ Depreciation & amortization	1,180	392	1,258	528
+/- Working capital	0	0	0	0
+ I/S Pension expense	390	235	700	500
- Cash pension expense	(310)	(136)	(450)	(420)
Net operating cash flow	$578	$228	($316)	($685)
- Non-aircraft capex	(400)	(175)	(375)	(100)
- Aircraft capex	(460)	(45)	(570)	(400)
+ Aircraft back-up financing	345	20	563	300
- Debt & capital lease payments	(807)	(688)	(758)	(601)
+ Debt issued	0	425	675	291
+ Asset sales	0	23	200	160
+/- Other	350	300	0	0
Ending unrestricted cash	$2,535	$1,497	$1,218	$1,425

Source: JPMorgan estimates and company reports.

AMR
- We assume AMR raises incremental $350 mn in capital in '05 although not necessary

CAL
- We assume CAL would need to raise an incremental $300 mn in capital in '05 to reach mgt.'s $1.5 bn YE05 target
- $425 mn of debt issued includes $75 mn of OnePass and $350 mn of Air Mike deal in 2Q05.

DAL
- $875 mn of capital raised in '05 includes $295 mn of Amex draw in 1Q05, estimated $300 mn GE second lien in 2Q05, estimated $80 mn other debt raised in 3Q05 and estimated $200 mn asset proceeds in 3Q05

NWAC
- Estimated $450 mn of capital raised in '05 debt issued includes $118 mn Pinnacle note in 1Q05, $101 mn Tokyo real estate deal in 2Q05 and estimated $160 mn from asset sales.

Our Bankruptcy Probabilities Are Largely Shared By the Market

By looking at credit market implied cumulative default probabilities (a more accurate analysis, in our opinion, than relying on equity values), the market ascribes between a 55 percent and 59 percent probability that Northwest and Delta will file bankruptcy within the next 12 months. Implied one-year risk for American and Continental, arguably two better-positioned carriers, is significantly lower, though their implied bankruptcy probability over the next four years remains in the mid-to-high 50 percent range.

Exhibit V: Credit Market Implied Cumulative Default Probabilities

Cumulative Default Probability Before Time Period Expires (in percent)

	1 year	2 years	3 years	4 years	5 years	7 years	10 years
AMR	12.5	29.1	45.2	57.1	61.1	69.9	80.0
CAL	14.6	30.5	44.4	54.9	64.6	72.3	82.0
DAL	59.0	75.6	80.1	85.0	87.8	93.9	97.8
NWAC	54.7	71.1	73.8	80.8	84.0	91.8	96.6

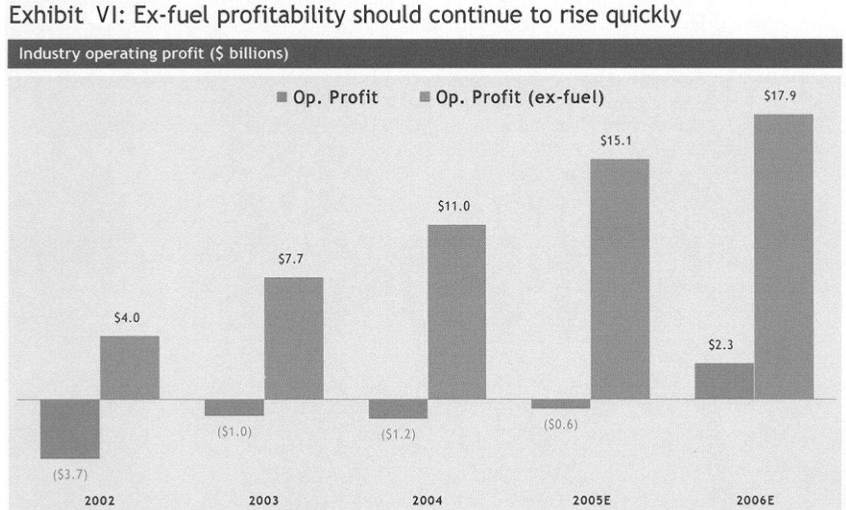
Source: JPMorgan, based on July 8, 2005 credit default swap quotes assuming 10 percent recovery in bankruptcy.

Can the Airlines Raise Additional Capital?

As of late, legacy airlines have been turning to non-traditional lenders. Delta has pre-sold frequent flier miles forward to American Express and tapped General Electric for a securitized loan. Continental recently sold miles forward as well and borrowed against its last major unencumbered assets (Air Micronesia, its Guam-based operation).

It remains to be seen whether or not other vendors and manufacturers are willing to invest further in their airline partners. Nevertheless, the proposed America West /US Airways capitalization includes proceeds from Airbus, hedge funds, traditional money managers, and an airline maintenance provider (Air Canada). Therefore, we can conclude that the legacy airlines could perhaps tap some of these same sources for additional liquidity, especially if pension reform positively impacts the credit standing of the legacy airlines.

Exhibit VI: Ex-fuel profitability should continue to rise quickly



Note: Based on U.S. non-regional Equity Research coverage universe (ie. excludes UAL & UAIR).
Source: Company reports and JPMorgan estimates.

Will Pension Reform Force Additional Legacy Airline Chapter 11 Filings?

Under some pension reform proposals, the airlines that sponsor defined benefit plans will face incredibly onerous payments. Relative to the 2005 required minimum contribution of $450 million, Delta has disclosed that its projected minimum funding under the current rules will increase by 33 percent in 2006 to $600 million, by 111

percent in 2007 to $950 million, and by 255 percent in 2008 to $1.7 billion. For Northwest, they are estimating $800 million in 2006, and $1.7 billion in 2007.

For this reason, both Delta and Northwest are likely to seek Chapter 11, and follow the damaging precedent set by United Airlines in terminating its defined benefit plans. This, unless a rapid decline in fuel costs or reform allowing for a longer-term amortization of deficits for sponsors agreeing to freeze DB plans comes into law, sometime within the next six months or so.

Continental is not as exposed to rising payments given the nature of the airline's defined benefit plan relative to Northwest and Delta. Nevertheless, the combination of the current oil price environment, current industry revenue, and higher required pension payments could force Continental to consider Chapter 11 as well in 2006.

AMR has enough liquidity-raising options and current liquidity to perhaps bridge the gap between today's environment and one where industry revenue and stock market improvement make required pension payments more manageable.

The issues surrounding credit balances and annual premiums, while important, are secondary to both the length of the amortization period and the interest rate to value liabilities in the cases of Delta and Northwest.

For AMR, the interest rate assumption and premium payments are most critical given the company's and its workers' desire to maintain defined benefit plans rather than the freezing approach embraced by Delta and Northwest management.

UAL is AMR's largest competitor. Although UAL's replacement defined contribution plan costs are significant, I nonetheless am concerned that AMR (and other legacy majors) will be at a strategic disadvantage to UAL going forward because of UAL's successful elimination of its defined benefit plans.

Multiple Bankruptcies Are By No Means Inevitable

Legacy Chapter 11 filings, with their accompanying toll on workers and expected service declines to smaller communities, are not inevitable, in our opinion. Legacy airline managements would much prefer to avoid the process, and instead remain concentrated on the task at hand—further reducing their competitive disadvantage versus the more youthful and fit, those airlines that have sprung up since airline deregulation. Their ability to succeed, however, is largely predicated on favourable airline-specific pension reform and/or sharply lower energy prices.

Should the government afford defined benefit sponsors the flexibility to stretch payments out over a period of several years, the sponsors must be forced to maintain fiscal discipline. Such discipline should include, though not be limited to, restrictions on the ability to repurchase stock, pay dividends, or offer increased defined benefits even if funded with cash.

Exhibit VII: Pension reform/stock market rally needed for legacy survival

US major airlines operating profit/(loss), $Bn

	PBO			Fair Value of Plan Assets			PBO % Funded			Underfunded Amount		
	2004	2003	2002	2004	2003	2002	2004	2003	2002	2004	2003	2002
CAL	$2,863	$2,362	$2,059	$1,281	$1,280	$866	44.7%	54.3%	42.1%	$1,582	$1,079	$1,193
NWAC	$9,254	$8,554	$7,638	$5,425	$4,806	$3,690	58.6%	56.2%	48.3%	$3,829	$3,748	$3,948
AMR	$10,022	$8,894	$8,757	$7,335	$6,230	$5,323	73.2%	70.1%	60.8%	$2,687	$2,664	$3,434
DAL	$12,140	$12,477	$11,682	$6,842	$6,818	$6,775	56.4%	54.6%	58.0%	$5,298	$5,659	$4,907
UALAQ	$13,577	$13,117	$12,673	$7,152	$6,961	$6,298	52.7%	53.1%	49.7%	$6,452	$6,156	$6,375

	Discount Rate			Expected Rate of Return			Actual Plan Return			Minimum Payments*		
	2004	2003	2002	2004	2003	2002	2004	2003	2002	2005	2006	2007
CAL	5.75%	6.25%	6.75%	9.00%	9.00%	9.50%	8.8%	25.2%	-12.0%	$266	$360	$450
NWAC	5.90%	6.75%	7.50%	9.50%	9.50%	10.50%	15.0%	28.2%	-12.5%	$420	$800	$1,700
AMR[1]	6.00%	6.25%	6.75%	9.00%	9.00%	9.25%	17.8%	23.8%	-0.3%	$310	$600	$800
DAL	6.00%	6.125%	6.75%	9.00%	9.00%	10.00%	12.0%	14.6%	-8.7%	$450	$600	$950
UALAQ[2]	5.84%	6.25%	6.75%	9.00%	9.00%	9.75%	12.1%	22.2%	-9.3%	TBD	TBD	TBD

* Without pension reform.
Source: JPMorgan and company reports.
1. AMR 2006/2007 minimum payments are estimated.
2. UAL's 401K/defined contribution costs are far from $0 and may total >$200 million per annum.

Conclusion

If the proposed pension legislation *not* supported by the legacy airlines is passed into law, we agree with the market that near-term Chapter 11 filings become significantly more likely. Put differently, certain airlines are likely to pursue a United-type strategy, whereby the PBGC shortfall will increase and taxpayers and plan

participants will suffer as a result. Alternatively, pension reform that does not result in onerous near-term deficit reduction contributions would likely materially diminish bankruptcy risk from non-fuel related issues, and otherwise allow carriers the chance to make good on promises already made to employees, while further protecting taxpayers and stakeholders in the process.

Thank you once again for allowing me to speak to you today.

Senator BURNS. Thank you. Now we have Mr. Robert Roach, the International Association of Machinists and Aerospace Workers and many years ago, I was a member of your good union.

Mr. ROACH. You can still be a member if you want to, Mr. Chairman. I'll sign you right up.

Senator BURNS. I don't think I can throw those baggies like I used to in Kansas City.

STATEMENT OF ROBERT ROACH, JR., GENERAL VICE PRESIDENT OF TRANSPORTATION, INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS (IAM)

Mr. ROACH. Mr. Chairman, thank you for the opportunity to speak today. My name is Robert Roach, Jr. I'm the Vice President of the Machinists Union. I'm appearing at the request of International President, R. Thomas Buffenberger. The Machinists Union represents more than 100,000 U.S. airline workers in almost every classification including ramp service workers, mechanics, public contact employees, and flight attendants.

Mr. Chairman, the financial condition of the airline industry to date is clearly miserable, and without drastic and immediate change, the future continues to be bleak.

September 11 was the start of the current crisis for airlines however the seeds for this calamity—excuse me, were planted many years earlier by the airlines themselves. When airlines were healthy, legacy airlines spent surplus cash by purchasing aircraft, foolish mega-mergers.

One noted exception is Southwest Airlines, which prudently expanded their profitable margins while increasing cash reserves for the inevitable. However, it should be noted that Southwest Airlines, which is 95 percent unionized, pays the employees the highest wages and benefits in the industry. I want to reiterate that. Southwest Airlines pays the highest wages and benefits in the industry, while still maintaining profitability.

At the same time, the airlines refuse to properly fund their pension plans and more than 100,000 participants at US Airways have lost money. To ask employees to further bail out corporations is disgraceful and to force retirees to subsidize corporate incompetence is unforgivable. The Machinists Union has met with ATA and airline CEOs on how to correct industry problems. I believe such partnerships should be continued and expanded. Norman Mineta convened an airline summit with government officials to jointly develop solutions to the problems. The IAM is proactive, but we cannot do it alone.

In the airline industry we have suffered more than six Chapter 11 bankruptcies. Hawaiian and Aloha being two of them, and United Airlines. My colleagues have said on this panel we believe Northwest and Delta are fastly approaching that line. We have re-

duced costs. We have lost pension money, and our health benefits have been reduced.

I believe what you're going to hear today is differences of opinion on how to fix the problem, and that you will hear we have the low-cost carrier, but the low-cost carrier advantage is because they are new and because they don't have the certain wages and benefits that they have today, but as time goes on they will catch up, that's why if you want to look at a low-cost carrier, look at Southwest Airlines as a model, that they are properly managed, and that they have been around 27 years and at the same time maintaining profitability.

We cannot sit here today and unlike my colleagues, if oil prices are what they are, then we must do something, and we believe that that effort is a coordinated effort. We don't think, as I said before this same committee on September 20, 2001, that you can just throw money at the problem. That happened in 2001 and we are in worse condition today than we were then. I think we need coordinated effort. I think with government, Department of Transportation or some Senate committee, Presidential commission, along with management and labor need to sit in a room with a commission and try to find coordinated solutions to the problems that will confront us in the future, and to do otherwise would be putting a band-aid on a bleeding artery.

I thank this committee for the opportunity to speak to them and present our point of view, and we are prepared to work with this committee and management to develop solutions to the problems. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Roach follows:]

PREPARED STATEMENT OF ROBERT ROACH, JR., GENERAL VICE PRESIDENT OF TRANSPORTATION, INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS (IAM)

Thank you, Mr. Chairman, and members of this Committee for the opportunity to speak to you today. My name is Robert Roach, Jr., General Vice President of Transportation for the International Association of Machinists and Aerospace Workers (IAM). I am appearing at the request of International President R. Thomas Buffenbarger. The Machinists Union represents more than 100,000 U.S. airline workers in almost every classification, including ramp service workers, mechanics, public contact employees and flight attendants.

Mr. Chairman, the financial condition of the airline industry is clearly miserable, and without dramatic changes, the future continues to look bleak. From 2001 to 2004, legacy carriers have lost more than $28 billion, and they are expected to lose an additional $5 billion in 2005.

Of the 146 airline Chapter 11 filings since 1979, in only 16 cases are the airlines still in business.

September 11, 2001, is often cited as the start of the current crisis for airlines. However, the seeds for this calamity were planted years earlier by the airlines themselves.

When airlines were healthy, legacy carriers spent surplus cash by purchasing unnecessary aircraft, irresponsibly expanding operations, and pursuing foolish mega-mergers. One noted exception is Southwest Airlines, which expanded prudently into profitable markets while increasing its cash reserves for the inevitable, recurring industry slump.

At the same time, these airlines refused to properly fund their employee pension plans, and now more than a hundred thousand participants and beneficiaries at US Airways and United Airlines have lost more than $5 billion of their promised pension benefits.

To ask employees to bail out failed corporations is disgraceful. To force retirees to subsidize corporate incompetence is unforgivable.

The Machinists Union has met with the ATA and individual airline CEO's to discuss how to correct the industry's problems. I believe such partnerships should be continued and expanded.

Earlier this year, I asked Transportation Secretary Norman Mineta to convene an airline summit so airline executives, labor leaders, and government officials could jointly develop solutions to the industry's problems.

The IAM has been proactive in our efforts to transform the industry, but we cannot do it alone.

For a snapshot of the financial condition of the airline industry, one only has to look at the unprecedented sacrifices employees have been forced to make just to keep this industry alive.

United Airlines

Almost immediately after signing contracts with the IAM in 2002, United Airlines came to its unions seeking concessions. The IAM engaged in these discussions over a period of several months in an effort to keep the company out of bankruptcy.

In support of the company's attempt to obtain a loan guarantee from the Air Transportation Stabilization Board (ATSB) in November 2002, ramp service and public contact employees agreed to cuts that would save the company $160 million a year.

This was happening as employees saw the value of the company stock held in their ESOP and employees' 401(k) accounts dwindling. Many employees lost tens of thousands in retirement savings as a result.

United failed in its attempts to reorganize outside of bankruptcy, and immediately after its Chapter 11 filing the company asked the bankruptcy judge to impose "emergency" pay cuts of 14 percent on IAM members. The judge authorized this request.

Laboring under these court-imposed pay cuts, IAM members went to the bargaining table and in the spring of 2003 agreed to permanent cuts in pay and benefits that would save United $460 million a year ($2.644 billion from 2003 to 2009). These concessions also included drastic reductions in retiree healthcare benefits for anyone retiring after July 1, 2003. As a result, many employees retired from the company in an effort to preserve these benefits.

United then took steps to cut retiree benefits for existing retirees and filed a motion in court to ask a judge to impose cuts if agreements could not be reached with the retirees' representatives. This heartless move saved United $50 million a year.

In the Spring of 2004, the ATSB denied United's bid for a loan guarantee a second time and, once again, United turned to its employees for more cuts. United also ceased funding its pension plans, the first in a series of steps which ultimately led to their termination by the Pension Benefit Guaranty Corporation.

In January 2005, United once again sought "emergency" pay cuts from the bankruptcy court—this time it was 11 percent. The IAM and UAL reached a tentative agreement on June 17, 2005, that, if ratified by the membership, will provide United with an additional $176 million a year from 2003 to 2009. Savings attributable to the termination of IAM member's pensions will save United another $217 million a year.

Successive rounds of cuts have delivered United annual savings of more than $853 million a year off the backs of IAM members. By the end of this bankruptcy case, IAM members will have sacrificed more than $4.6 billion for United Airlines, which is about three times more than the value of all loan guarantees given out by the ATSB.

US Airways

In US Airways' first bankruptcy in 2002, IAM members agreed to two rounds of contract concessions totaling $276 million per year, or $1.8 billion over 6½ years.

Pay was cut by an average of 7.5 percent. Employees also experienced drastic increases in their contributions for healthcare coverage, which had the effect of reducing take-home pay even further. Employees' share of healthcare premiums roughly doubled for single coverage, and almost tripled for family coverage, translating into an additional reduction in take home pay of 1 percent to 3 percent, depending on the employee's classification.

Immediately after filing for bankruptcy for the second time in as many years, US Airways management petitioned the court to impose "emergency" pay cuts of 23 percent for all union-represented employees, as well as reduced contributions to pension plans. Management and salaried employees' pay was reduced by only 5 percent to 10 percent.

On October 15, 2004, the bankruptcy court allowed an emergency 21 percent cut in pay.

US Airways then approached the IAM to negotiate permanent reductions to pay and benefits, and filed a petition with the bankruptcy court to reject the IAM's collective bargaining agreements. Ultimately, the parties were not able to reach agreement and the court granted the company's request to abrogate the IAM's collective bargaining agreements on January 10, 2005. IAM members then voted to accept the company's "last and final offer" that involved pay and benefits reductions even more drastic than what were ratified in the first bankruptcy.

Under these latest terms, IAM members will give up $346 million a year in pay, benefits, and work rules. Mechanic and related employees will see their pay reduced by an average of 15 percent. Almost all Utility jobs are able to be outsourced, and roughly a third of mechanic and stock clerk jobs can be farmed out.

In addition, the defined benefit pension plans were terminated, with the sole exception being the IAM's multi-employer defined benefit National Pension Plan for our Fleet Service members, who experienced pay cuts of 12.8 percent to 20 percent. In addition to these drastic reductions in pay, holidays, vacation accruals, sick leave, and retiree medical benefits have also been significantly reduced.

US Airways employees have accepted up to ⅓ reductions in their standard of living in a very short period of time. The typical middle class household budget does not have a cushion anywhere close to ⅓ of take-home pay; to be able to adjust to these kinds of reductions. Workers and their families are being forced into dramatic and drastic changes that affect the most basic, personal decisions, such as where to live, where and how to educate children, and making very hard choices regarding medical care.

Many employees have concluded that a job with US Airways is one they cannot afford to keep, and as a result, the company is facing manpower shortages in many locations. This difficulty in finding employees willing to accept the meager wage scales imposed through bankruptcy is what caused US Airways' Christmas meltdown in Philadelphia last year. That event clearly demonstrates the effect of low wages on the reliability of the industry.

Hawaiian Airlines

When Hawaiian Airlines approached its unions seeking concessions in an attempt to stay out of bankruptcy, the IAM stepped up to the plate.

However, the company failed in its attempt to reorganize outside of bankruptcy and filed for Chapter 11 reorganization in the spring of 2003. As part of the reorganization, a Trustee was appointed due to serious concerns on the part of creditors about actions taken by the prior CEO.

The Trustee sought cost reductions of more than $1.5 million from IAM members. The IAM and the company ultimately reached an agreement in the fall of 2004. Because of the sacrifices made by IAM members, the company successfully restructured and recently exited bankruptcy.

Aloha Airlines

In order to obtain $40 million in ATSB funds, employees at Aloha Airlines agreed to a 10 percent across the board pay cut in late 2002, designed to save the company $37 million annually. IAM members were willing to make these sacrifices to keep Aloha out of bankruptcy.

Despite these cuts, management was unable to turn the airline around. The company filed for Chapter 11 protection in December 30, 2004, and returned to employees seeking an additional 10 percent pay cut, on top of the cuts agreed to just two years before, as well as reductions in health benefits, changes to work rules, and a freeze in benefit accruals under the company's defined benefit pension plan.

To force their demand, management went to court to seek abrogation of the IAM contract. IAM members ratified a second round of concessions this past winter. Despite reducing pay by more than 20 percent, the airline continues to struggle to reorganize.

Air Wisconsin

Air Wisconsin was once owned by United Airlines, but for many years has operated as an independent express carrier for United. When United filed for bankruptcy, it sought to restructure contracts with its express feeders and as a result, in 2003, Air Wisconsin came to its employees seeking concessions. IAM fleet and customer service members agreed to significant cuts in pay and benefits in order to preserve their jobs at the airline.

Continental Airlines

As part of a company-wide restructuring, Continental Airlines is seeking to reduce IAM-represented flight attendant costs by $72 million annually. Discussions with a Federal mediator are being scheduled.

Alaska Airlines

Alaska Airlines management has demanded concessions and even locked out nearly 500 IAM ramp service members in Seattle, WA. By outsourcing our members' work to the lowest bidder, Alaska Airlines now ranks dead last in the DOT's on-time performance ratings. This is another example of how an airline's short-sightedness is negatively impacting the reliability of our nation's air transportation system.

Northwest Airlines

Northwest is also seeking significant cost savings from employees and termination of pension plans in a bid to avoid bankruptcy.

Mr. Chairman, members of the Committee, the financial condition of the airline industry is an absolute disaster. Passengers have returned since 9/11, but the continued reliance on failed business plans jeopardizes our air transportation system.

Southwest Airlines pays their employees more than any other major carrier, yet remains profitable, so the industry's problems are clearly not the result of high labor costs. Nevertheless, employees have given more than their fair share, yet airlines are still struggling. Fuel prices are high, and employees are repeatedly asked to subsidize artificially low ticket prices.

The industry needs new ideas. Airlines can't continue refusing to charge at least what it costs to provide their service and then claim financial emergencies.

I urge this committee to explore ways to correct the suicidal pricing plaguing the industry. Whether it be a mandatory fuel surcharge or other government intervention, some re-regulation of the industry is clearly necessary. Left alone, airlines will price themselves out of existence.

I thank the Committee for inviting us to participate in these proceedings and listening to our concerns.

I look forward to your questions.

Senator BURNS. Thank you, Mr. Roach, for your testimony. I'm interested, Senator DeMint, do you have a statement this morning? Thanks for coming.

Senator DEMINT. Just wanted to listen.

Senator BURNS. You've come to a great place. I mentioned in my opening statement and the reference toward, you know the new carriers, the new low-cost carriers and Southwest as a model that so far has been very profitable, but I would look at them and say well, we know that they knew how to handle their fuel costs, that over time will run out. In your estimation, Mr. Roach, how long will it be that they will, before Southwest faces the same problems as say our legacy carriers?

Mr. ROACH. Well, they are confronting the same problems today. Fuel hedging slowly decreases up to 2009. What has to happen, and I believe Southwest management is working toward solutions as they go along and managing the business as they go along to be prepared for that. I think if you look at the pricing of airline tickets on Southwest Airlines, versus US Airways or United, you'll find that United and US Airways are charging less for tickets than Southwest Airlines, and so there is a serious problem. I think that we work with Southwest Airlines, and we represent 10,000 people there. We work with them to craft solutions to the problems that they will confront beyond 2009, such as ticketing problems, working with them in the areas of helping to move passengers through the airport, and having efficiencies in place, because, again, if we are going to have $60 a barrel of fuel, we can't just act like it doesn't exist.

We have to understand it's going to exist. We have to look at pricing of the ticket. Every Senator flew in here. When they got to a cab at the airport, they didn't pay a surcharge. So you have to price the profitability, and that's what Southwest Airlines is doing.

Senator BURNS. Mr. Baker, do you have a comment on that, how long will it be before they face some of the challenges that legacy carriers face?

Mr. BAKER. Well, I would echo the point that they are facing many of those problems today. Our analysis suggests that if not for their hedge protection on pricing, on fuel pricing, they wouldn't be capable of producing profit in this economy, and while it's a factual statement that their labor rates are above the industry average, Southwest management now concedes that that puts them at a competitive disadvantage. And furthermore, many of the pricing changes that are taking place at the legacy level have negatively affected Southwest's performance, the revenue performance in cities such as Fort Lauderdale; Hartford, Connecticut and other secondary cities.

I would suggest that over the next several years, Southwest will have to tackle these issues. They have conceded that it will be difficult to achieve wage declines because those declines are going to have to take place if they are going to remain competitive with the further-improving legacy carriers.

Senator BURNS. Well, I go to the airports right now and I'll tell you what, I have never seen airports more full, and I have never seen Washington, D.C. so full of tourists since 9/11, so the travelers are back. As I mentioned in my statement, though, I come from a State that has a lot of tourist dollars and recreational flyers. But we also have a very healthy network of business up there and I am concerned about the rural connectivity because of the financial conditions of the legacy carriers. If it wasn't for the hub-and-spoke situation, well, I think we fall into a situation where we could lose much of our service into rural areas. I initially asked, why do airlines insist that it's so expensive to operate in the rural markets? From what I can tell, the planes seem to be full, and I know what it cost me to fly to Billings, Montana, roundtrip. You could make almost three round trips from Dulles to San Francisco. And I have a hard time justifying that, but I also know what the costs per mile are, and maybe what you've got to have, and you pretty much have to have a face in every window whenever that airplane leaves the airport, so I'm really concerned about those trends, so looking ahead, Congress has provided billions of dollars of direct and indirect assistance to airlines, and they continue to lose money. Chairman Stevens and I were discussing how to refinance the FAA. And your suggestions today, Mr. May, I take it you said over a thousand communication systems. Can you give me an example——

Mr. MAY. 14,000, Senator. And it's extraordinary. We have an infrastructure that's been built up within the air traffic control system over the past 35 years that is more.

Senator BURNS. Can some of that be claimed as redundancy in case of emergency?

Mr. MAY. Some of it can be claimed as redundancy in case of emergency, but I don't think we need triple and quadruple redundancies, and I think that there is the capacity to do a transition—I hate to use this phrase before this committee, but transition to digital that might be particularly appropriate for the airlines.

Senator BURNS. Appropriately delayed by the way.

Mr. MAY. I understand.

Senator BURNS. Senator Inouye?

Senator INOUYE. Listening to the testimony, I gather that there are two major causes of the airlines' current difficulties, fuel prices and the government, taxes and fees. Then we hear the word globalization. And my question is how do we, number one, compare to the operations and the financial conditions of airlines abroad in Europe and Asia, for example? Ms. Hecker or anyone else?

Ms. HECKER. I think Mr. May may have more detail, but I think generally the studies that have been done is that the U.S. does not compare favorably, that the top performing carriers because they have a very high growth market in Asia, and there has been a view that there has been more moderation in the U.S. in making the kinds of adaptations to the new market environment that, for example, Asian carriers have and some have failed. It's not as if they have all succeeded, but their growth rates, their efficiencies, their business strategies have admittedly in a growth market been largely successful.

Mr. MAY. Senator Inouye, I think it's important to note that there are some very fundamental differences between some of the major European and Pan-Asian carriers, and those here in the United States. They rely to a very great extent on long haul international routes. The major big six and so-called carriers here in the United States do a tremendous amount of domestic short-haul business here in the United States, which is the essence of the hub-and-spoke system. As Senator Burns pointed out, without that hub-and-spoke system, we wouldn't have service to a lot of small and rural communities represented by this committee on a daily basis, and the competitive nature of the low-cost carriers is frequently in that domestic business, and in particular, for medium-sized communities in that system. So that the 85 percent competitive route structure of the low-cost carriers with legacy carriers is having a dramatic impact on domestic yields for our carriers.

We are actually doing and comparing, very favorably with the international carriers on our long-haul international routes, but as my friend Giovanni Bezziana would tell you, they have many of the same kinds of issues with taxes, fees, and fuel costs that we do.

Mr. BAKER. Just to throw some numbers on top of that, Senator, for example, the U.S. carriers 75 percent of revenue is derived in the lower 48, the remainder coming in longer haul, and across the oceans, and internationally. For European carriers, those numbers aren't reversed and for that reason, their exposure if you look at British Airways or Lufthansa, their exposure to low-cost carriers is less, because they don't fly those long-haul routes. That's for a very good reason. The low-cost model, which is a low-labor cost model is not applicable to long haul travel. That's the reason Southwest doesn't fly across the ocean, nor does Jet Blue, so it's a reversal of the portion of revenues that are expensed to low-cost carriers that, I think, in large part explains the financial difference between the two geographic sectors.

Senator INOUYE. None of the airlines of the United States have any government ownership interests, but, on the other hand, you take Saudi Airlines, and I suppose it's owned by the family, the government, Japan Airlines has a government interest in it, China

Airlines may be completely government-owned. Is that a level playing field for us?

Mr. MAY. Makes it particularly difficult for us, Senator Inouye, but it is the reality of what we are left to deal with. Nobody ever said it was going to be a fair situation, and it does have an impact, but again, I think the biggest differences are not our ability to compete on an international scale, but the difficulties we have with more domestic short haul.

Senator INOUYE. An additional cost has been imposed upon our citizens, the cost of security, national security, and for example, airline security has just sky rocketed. In Europe and Asia, who pays for the security, airport security, for example, metal detectors?

Mr. MAY. I'm not an expert on international security, but it's my understanding that more of it is paid by the government, as opposed to the individual carriers. In the United States, we pay either direct fees or mandated, indirect mandated costs, a billion dollars a year for aviation security right now.

Senator INOUYE. That's what I wanted to get to, because recently, it has been suggested that the airlines pay for airport security. And I don't think that's the case in Asia and Europe. It's a matter of their national security, isn't it, Mr. Baker?

Mr. BAKER. That's correct. I don't have the figures in front of me, but I would echo Mr. May's comments that overseas governments tend to be much more generous in terms of affording that level of security to airports and passengers than here in the states, where it's largely funded by the carriers out of ticket prices.

Senator INOUYE. Mr. Roach, what has been the response of the Administration on your suggestion that there be a summit?

Mr. ROACH. We had several meetings with Secretary Mineta. We visited with him in New York very recently. We have not established any summit meeting. While it has been favorably discussed, we have not had the meeting, and we think it's important.

Senator INOUYE. Are they open to your suggestion?

Mr. ROACH. Yes. Secretary Mineta has been fair to establish, we talked to several CEOs of several carriers, United, US Airways, Northwest Airlines and they all seem favorable to getting it done. We think that the Secretary of Transportation, or some government agency, needs to call the meeting and then we'll get everybody in the same room. We have had this on the Secretary's plate. Similar meetings have been fruitful, but we think it's important to get everybody in the same room to start talking about these issues.

Senator INOUYE. While all of this financial condition is existing, what about equipment? Are we keeping up?

Mr. MAY. Senator, I think one of the most positive messages we can deliver to this committee is that safety in particular is at an all-time high. We have never had a more safe period in the history of our industry than we've got going right now, and I think that's a result of the extraordinarily, fine cooperation between the folks that Mr. Roach represents and our management, because no matter how great our difficulties, we have worked together to that common goal of keeping safety first, and we have got some extraordinary equipment that we are able to work with and take advantage of.

Senator INOUYE. Mr. Chairman, I have got a lot of questions. May I submit them?

Senator BURNS. We can submit them and they can respond to them. Senator DeMint.

STATEMENT OF HON. JIM DEMINT, U.S. SENATOR FROM SOUTH CAROLINA

Senator DEMINT. Thank you, Mr. Chairman. I'm just sitting here trying to sort out how to fix this, and you have given significant review of the problem, and I think we have heard that some of the problems—clearly mismanagement over the years, as Mr. Roach talked about overreaching during good times, perhaps not making good decisions. We have also heard that labor used as considerable leverage over many years to push salaries and benefits way beyond sustainable levels.

We have heard about the waste of FAA and problems with fuel costs, taxes and fees, and you know, my inclination is to say maybe we should sit back and let the market try to fix this, but I do see the government's hand in this and we perhaps intertwined to let it go. But it doesn't seem with all of what we have seen with the industry management, the labor that the government should come in and just try to fix this problem because we can. I'd just like to hear more from some of our witnesses of, I mean I don't know how we can sustain an airline industry with so many losses.

I'm perplexed at how it continues to attract capital. And this is seeing something where the market really needs to work here, and much less government, but I'd be interested in any comments that you have on what the government should do at this point.

Mr. MAY. Senator—I'll jump in here and I know Mr. Roach has some ideas, too. Mr. Baker said a minute ago——

Senator BURNS. Jim, pull your microphone a little, would you please.

Mr. MAY. Thank you, sir. Mr. Baker said the market for Continental and American, except for fuel, would have been the most profitable quarters they have had in the history of the business, and I think the productivity gains that we are making, all of the changes that are taking place in the industry, and we make no bones we have been less than perfect in managing the business over the years, I think all of those changes have been extraordinary, and are leading to sustained profitability.

Once we begin to address the uncontrolled costs, those costs over which we don't have any control and they are fuel, which has had a dramatic impact on our business, taxes and fees, and unfunded mandates, we spend $50 billion a year for an industry that only earns roughly 80. But here in the United States on taxes and fees, security mandates, so on and so forth. So I would love to sit down with Mr. Roach and bring our CEOs together and talk about how we need to reform the air traffic control system, how we need to reduce the impact of taxes and fees, and Senator, if you've got some magic for $60 oil, I want to hear it, because we are at wit's end.

Mr. ROACH. It would be nice to let the market take care of the situation, but the market does not take care of it. For example, United Airlines and US Airways are currently in Chapter 11 insulated from the market and everybody else, Northwest, Delta, Conti-

nental, the other carriers, Southwest are now paying bills, and this is—the court is now running those through airlines. So if you can stay into Chapter 11 for 3 years and not go to the government and dump your pension plans, then the market is not taking care of the situation. It is the government, it is the courts causing the Northwest, Delta, everybody else to now follow suit, but the protection has been given through the law on the Chapter 11, so it is again, I think, very important that we try to grab solutions collectively. I don't want to sit in the room and negotiate contracts with everybody.

We need to sit down and figure out what it is we are going to do collectively working with the government. I don't want the government to come in and mandate what we should do. We should have solutions, and we should have some input from a governmental agency as to what the industry can do to fix it and work together.

Mr. BAKER. Senator, the testimony that I submitted today dealt with the issue of pension reform for the airlines. I think if carriers were seeking something to symbol as a handout, if you would, they would follow the precedent set by United Airlines. File Chapter 11, rid themselves of their obligations and put those obligations at the expense of workers to the government and to taxpayers. That to me smacks of subsidization. What certain carriers and lawmakers have proposed is simply allowing the carriers more time to make good on promises they have already made, and, therefore, substantially diminish in my opinion the near-term risk of bankruptcy.

To me, this is a proposal that would potentially be less burdensome on workers and taxpayers.

Ms. HECKER. If I can just add one point; that there is no doubt that pensions are an extremely serious issue. GAO, though, has done work widespread across the economy and the issue of pension underfunding, and pensions pushing liquidity problems on many industries is not exclusively a problem of the airline industry. And our work has vigorously called for broad and comprehensive pension reform that fixes the problems that the current system has created, both in this industry, and many others, where we have a nationwide severe crisis in the entire defined benefits system.

Senator DEMINT. Thank you, Mr. Chairman.

Senator BURNS. If it's anything that's getting our attention in this town right now is a situation we find with these pensions. This has the possibility of impacting the American taxpayer, to a greater extent than the S&Ls, and there are some folks up here that are very, very concerned about that, especially in the situation, and in light of our budgetary problems now, and I'm very, very concerned about it, and even though as your testimony would signify that only 6 percent of the operating is of their total overall operating capital is impacted by the pensions, and that sounds greater to me than the figures would indicate.

Mr. ROACH. The issue of pensions, I'd like to say on behalf of our organization is that we saw this problem in 2000. This is not a new problem, and we went to the airlines and said this is a problem. You're not in the pension business. Let's sit down and work this out. And they refused. Why they refused—because under current pension law you didn't have to make any contributions to those

pension plans, but this is not just something that happened yesterday. We saw the problem coming and we said let's fix the problem before it becomes a crisis, and again because of the law, you're able to push these payments back and then all of a sudden they were due. The bill came due and he couldn't pay it so again, and I may sound like a broken record, we need to sit in a room together to figure out what to do next, because how do we address this problem in 2000, I suggested by the Machinists Union we would not be here today. Believe me.

Senator BURNS. Can I suggest to you that the same thing is true in Social Security, Mr. Roach, and we are not getting much response from anybody to fix that report before it becomes uncontrollable and cannot be fixed. But then, as you well know, we all got ingrained in all of us here in this country that nobody gets excited. I can go down to your farm and tell you you're going to have to repaint your barn in 2015, do you want to sign the contract now. I doubt that you would do that. And that's, that's the American people, but right now, the cry has gone out—we have to fix these other funds, but nobody wants to do that now, but they will when those checks are 2 weeks late or they are halved in two. Senator Lautenberg.

STATEMENT OF HON. FRANK R. LAUTENBERG, U.S. SENATOR FROM NEW JERSEY

Senator LAUTENBERG. Thanks, Mr. Chairman. I'm sorry that I wasn't here earlier. As everyone knows, there are always competing committees, and this one ranks very high on my agenda, but the other one had to deal with chemical safety, and in my State of New Jersey, we worry about those things. Honestly, I also worry about the airlines. The service that commercial aviation provides to our country and our world is essential. The expansion that this country has had over the years would never have been possible were it not for the availability of commercial air service, so I look with considerable misgivings about what might happen in the aviation industry if the price of oil and other expenses continue to increase.

However, I'd like to ask a couple of questions that relate particularly to the pension problem. I come out of industry. I ran a pretty good-sized company, a company that I started with two others and now has 40,000 employees. We had a lot of experience in running the company and managing the works, and I know one thing: pension plans are under assault like the Chairman mentioned. Lord knows where we go in terms of satisfying the belief that people have that if they work for Company A or Company B and they had a pension plan and that 20, 25 years later they could go on with life and their families. Unfortunately, many are not able to do that. And it's not particular to the aviation industry. It's also true in other industries, especially manufacturing industries throughout our country.

And so I must ask the question—kind of a generic question—that is: did everybody get treated equally when it came to protecting the pensions of employees in view of either credit reorganizations or bankruptcies? Are executive pension plans better funded than employee plans? Are executives taking the same heat that rank-and-

file employees take? Did they run the same risks as not being able to get their pensions protected? Mr. May, can you comment on that?

Mr. MAY. My, I am not an expert on the issue, Senator Lautenberg. I will offer two brief observations, and would be happy to do some research and come back to more specifics, obviously. My sense is that defined benefit plans, no matter how they are constructed or who they are for, are facing some very real and significant difficulties, and it's not just in the airline businesses. As you have pointed out, I was with somebody from General Motors the other day, and there are a number of concerns across industry.

As to compensation for our executives, I think it has been slashed significantly across the board. I think there are very few of our executives that are coming anywhere close to their peers in other industries to compensation. As to whatever specific retirement plans that those executives may have, I don't happen to be privy to those. I know most of it, I think you'd be far more expert in this than I, are filed in disclosures with the SEC, and I know it's public information, and I would suspect that we could find the answer to that question there.

Senator LAUTENBERG. Mr. Roach, how do you see it?

Mr. ROACH. Well, traditional pension plans both executives have, which was shown in American Airlines when they had pay cuts and $45 million put aside in special funds for their executives. I think there has been testimony in other hearings that there are bonus payments that are made. They don't call them pensions. But you are talking about millions of millions of dollars that go to executives, while employees pension benefit plans are being cut. It's not a level playing field.

Senator LAUTENBERG. I just wonder whether reserving pension plans or termination programs for executives has in any way impaired the airline's ability to have some additional funding, in addition to the pain and the trauma that it causes for employees who have worked and depended on these pensions for a long time.

Mr. ROACH. Not only does it affect the current employee, it affects the retired employee. The employee that is retired is expected an amount of health care, health care costs have increased in certain cases, but employee who has depended on a dollar amount for months. It has been very difficult as we create a lot of morale problems at the airlines because employees were planning to retire. As you move the older employee out, younger employees come, it also reduced costs. So it causes employees to stay around and work longer.

It has created a lot of serious problems with people again being focused, and that goes back to the question of security. Employees must be focused at airports. They should not be focused about should I pay my mortgage. They have to be focused on the traveling passengers, as well as employees. I think there is a serious problem. A lot of times in this country you don't want to confront things until there is a crisis, and I certainly agree with them and that's why today we have proposals with Continental Airlines and Northwest Airlines to fix their pension plans in coordination with some of their ideas that we have to fix the plans. We have to bite

the bullet. We have to do what is necessary to get these problems fixed.

Senator LAUTENBERG. Mr. Chairman, I would ask if you would consider one of these days having a hearing specifically on this question. I think it's important to find out what kind of obligations the Pension Guaranty Fund is going to have. It could be enormous, and I don't know what we do at that point.

Senator BURNS. I would say to my friend that that is not under jurisdiction of this committee, but it sure has an effect on how we set policy for our airlines. I'll guarantee you that.

Senator LAUTENBERG. Information search would be a good idea if we could do it. I would ask whether recent events have effected equally the lower-cost carriers versus the legacy carriers. The competition is robust, as I see from some of the financial statements. Some of the regional and the smaller airlines seem to be able to weather this storm better. Is that true, Mr. May?

Mr. MAY. Yes, sir, it is. And let's maybe try and divide the business into three parts. The regional carriers are either wholly owned, or have significant operating relationships with the major carriers, and they have been earning profits for some reasonable period of time because they effectively have a guaranteed income because of the contractual relationships they have with their brothers.

The Independence Airs and the smaller low-cost carriers are, Robert has pointed out Southwest is a prime example, have had a mixed bag. Independence Air, I think it will come as no surprise reading the papers, is losing a very significant amount of money. Herb Kelleher, who is on my board and a great contributor to our industry, has made it abundantly clear that if it weren't for the fact he has hedged at $26 for oil, he would have lost money over the last year or so. And although he has hedges that aren't quite as favorable going forward, they rise up into the 40s. A 40-some dollar hedge looks awfully attractive when oil is trading on the Nynex at 60, so I think there is a mixed bag among the low-cost carriers, but they are being impacted as well as our carriers are, although it's easy to point out that the costs for the seat model is lower for those carriers. I think Mr. Baker is the bigger expert in this area.

Senator LAUTENBERG. I would be interested in your comments, Mr. Baker. In terms of the financial viability, does the industry's structure permit the legacy carriers whom we desperately need, to survive through these drops and these periods of high-cost operating expenses?

Mr. BAKER. I believe most of them are well on the way to ensuring them whether it will allow them to endure the business. I would point out that in the first quarter of this year, if we just strip out fuel expense from both sub-sectors, low-cost carriers and legacy carriers, we actually witnessed the first year-on-year decline in low-cost carrier profitability in several years, whereas non-fuel profits, if you will, of legacy carriers, were up in excess of 25 percent, and the reason we witnessed the decline in low-cost carrier profits is because it coincides with these recovery efforts with the legacy carriers, choosing to no longer fall back and instead stand their ground and compete more effectively with these carriers.

There is no question in my mind, Senator, that a significant reinvention of legacy cost structure is under way. It's just that that reinvention is being masked right now by the escalation of crude prices.

Senator LAUTENBERG. Mr. May, Mr. Chairman—I'll conclude with this. I assume that you look at the air traffic control system and see how it's functioning. I think it functions very, very well, but I am concerned about the anticipated controller retirements, as well as the increase in volume of flights as we go to more regional jets, more activity in the air. We need a lot of space for military uses, *et cetera,* and the air space is not infinite. How will carriers be affected? Have you looked at that, sir, in terms of what the financial impact might be? Perhaps longer delays and problems that the FAA might not be able to quickly find solutions for?

Mr. MAY. Senator Lautenberg, I think as I said in my oral testimony, we should take the current ATC system and retire it to the Smithsonian, where it can be admired as one of the marvels of 1950s technology. It is capable of handling the traffic we have today. It is fully incapable of handling the traffic for the future. One example, Net Jets, has well over 600 aircraft. They are flying in and out of Teterborough in your state. That's a phenomenon. We have ultralight jets on the horizon. We have any of a number of regional carriers that are putting more planes into the system, and fewer of the larger 57s, 67s, *et cetera,* so I think we have got a very significant problem on our hands in the future, and we are going to need to seriously engage in making it an exercise in difficult choices to make some fundamental change to this system from top to bottom.

We have got to go to a fully-digital GPS-based system that can handle the traffic that's coming our way.

Senator LAUTENBERG. Mr. Chairman, an observation that I would like to be permitted to make is that I always believed that FAA should be operating similar to companies where the CEO is employed to do a job over a period of time, regardless of what political party is in place or that kind of thing. An organization where the mission is professionalized and we thanked the people doing it. We have good FAA people, but the fact of the matter is one of the reasons the system is so antiquated, and when we try to change it, there are discontinuities created along the way. We have spent billions of dollars with some of the top agencies in the country in trying to reform the air traffic control system, and every time we had a start, we run out of cash. It is a system, and it works surprisingly well, but it's in overload mode most of the time. Thanks, Mr. Chairman. Thank you all very much.

Mr. MAY. Senator, if I might be permitted, I know this is heresy, but if we could have maybe the Congress of the United States spend a little less time micromanaging the details of the FAA as to where ILS systems are going, and so on, and so forth, and earmarks, it would probably operate a lot more efficiently.

Senator LAUTENBERG. Shocking suggestion.

Senator BURNS. It is heresy. Let's go over three areas. There are some areas of confusion, and in the area of Chapter 11 bankruptcy, I think we have kind of ironed that out this morning. Buying new aircraft. Yesterday I read the testimony of all that are here today,

Mr. Roach's testimony questions the purchasing of new aircraft by struggling air carriers. Do any of you refute that argument, or are there long-term gains on that investment? Do we talk about efficiency, or is it just a bad business decision when we start talking about the replacement of equipment?

Mr. ROACH. I think my testimony is the timing. You have to purchase new aircraft and you have, because there is more aircraft, it becomes less efficient, other aircraft becomes less efficient and it can't be maintained when companies can't pay their bills and ordering new aircraft, it's a timing issue.

Mr. MAY. I think the other factor that's important, Mr. Chairman, is that I think our carriers, in particular the larger carriers, have learned a very good lesson from Southwest. Southwest has a single type of aircraft, 737. They are all effectively identical with the exception of the paint colors on the outside, and so they have managed their fleet in a very effective way.

I think what we are seeing today is that many of the legacy carriers are significantly reducing the numbers of different airplanes in their fleet, and they are trying to upgrade, as Mr. Roach says, from a fuel efficiency point of view. I was with Boeing on Monday of this week up in Hartford, Connecticut, we were talking about the 787 which is the most fuel efficient aircraft ever designed, I think, and we are all looking for those efficiencies in our fleets, and we laid literally hundreds of aircraft down in the desert to get rid of older, less fuel efficient planes and bringing in more fuel efficient planes, so it is a process of renewal and standardization that is important for the industry.

Senator BURNS. On the efficiency part of these new airplanes, is there anywhere we can go to see what the airlines use to measure the payout or the return on investment, as far as efficiency is concerned? I say that because we are dealing with some new technologies here on this committee with regard to lighting.

When you look at optical lighting, that these old light bulbs that we see here today are on their last legs. A lot of people don't realize that, and you see this optical lighting showing up in our traffic lights more than anywhere else. They use from 30 to 40 percent less electricity. So the payout, or the payback, for that investment is rather large. Do we see this kind of a situation in the aircraft that's coming onboard now from the 787 or other types of aircraft that's being introduced?

Mr. MAY. I'm sure in our engineering team, along with Boeing or Airbus engineering teams would be happy to provide you and this committee with background.

Senator BURNS. Now in the area of leasing, some in the industry have been critical for the role aircraft leasers have been playing by providing outside cash and loan support. What role, good or bad, do you think this section of the industry is having, and what do you see their future role, how will they evolve in the future? What role will they play? Mr. Baker, you're probably in a better position to address that.

Mr. BAKER. Mr. Chairman, I think one thing that really separates the current airline crisis from that which followed the first Gulf War, and that being of somewhat less significance, is in fact the rise of leasing companies. We were unable to witness the num-

ber of actual liquidations, names like Eastern, Banff, carriers no longer with us, and the removal of their capacity played a role in the resurrection or the return to profitability that we witnessed for all carriers during the mid-1990s.

I think the role of the leasing community is largely what is preventing any liquidations from taking place, so I do think it is yet another example of a barrier to exit, and the airline industry is notorious in terms of there being very few barriers to entry. You and I are free to start an airline with surprisingly little red tape and capital requirement for us to actually start an airline, and then ceasing to operate that airline is entirely different. That said, the leasing community clearly has to be mindful of the overall value of the demand for aircraft globally, which is why leasing companies such as GE are in fact playing an important, and critical role in the resurrection of carriers, the redesign of carriers such as Delta Airlines. They are now both a potential or an actual barrier to exit, but they are also aiding the recovery efforts of these carriers.

Senator BURNS. Tell me about in the airline industry. Why is it still attracting capital even though it has a very poor performance record?

Mr. MAY. Senator, that's a great question, and I wish I had the answer for it. I can't remember the exact number, but there is something on the order of 16 to 20 applications resting at the FAA for people coming into the business, as tough as it is, and as horrible a record as it is, right now.

Ms. HECKER. I think your interest in the role of manufacturers and lessors is right where the answers are, though. Those firms have been making money for a number of years, so they are playing the role, yes, in some recovery, but they are also keeping the capacity in the system, despite the limited pricing power, so it's a dynamic that is a very important one in the sector.

Senator BURNS. That tells me that I should be selling baggage carts rather than investing in the airline stock. Is that, everybody is making money but the airline, right?

Mr. ROACH. Historically in its business everybody connected with the airline, with caterers, people that sell, lease airplanes, fix airplanes. They all make money. It's the airline industry itself that doesn't make money. You're 100 percent right.

Senator BURNS. We'll have to look into that, I suppose. I started out there, when I came out of the Marine Corps, I worked for an airline. Now, the $64,000 question. That's not very much. Looking at the debt, looking at the asset-to-debt ratio, how much more time have we got before they are all in Chapter 11?

Mr. MAY. Senator, how much longer are we going to have $60 oil, and is it going to go to $70? I think you can measure the successful livelihood of the business in great measure with the price of oil. It's that important to the equation.

Senator BURNS. That we have very little control of right now. Right now China and there are a lot of foreign countries that are in the oil business, and are driving oil prices right now. But I would say on the other hand in Sydney, Montana, I don't see many, and Williston, North Dakota, if you know what I mean.

Mr. BAKER. Senator, I would suggest, barring a material price in crude or material pension relief, Northwest and Delta will be facing

Chapter 11 decisions within the next 6 months. Other carriers are in better positions in terms of liquidity profiles, like Continental. I would suggest if nothing changed, if revenue trends stopped improving, if fuel costs stayed precisely where they are at the pump today, that Continental would be facing a Chapter 11 decision sometime toward the end of 2006, beginning of 2007, and American once they went through the actions consistent with a carrier trying to avoid the process, so selling off key assets what have you, making an additional return to labor for another contribution there, they would be facing a late 2007, or late 2008, bankruptcy decision.

Senator BURNS. Is consolidation an answer?

Mr. BAKER. I don't happen to believe that it is. I think that the America West-USAir example is probably the first and last significant form of consolidation that, that type of consolidation that we'll see for sometime. I do believe that over time, assets belonging to failing carriers as they exit the industry, they will, will ultimately emerge with fewer airlines, but I think it's more likely to occur if and when failures take place than through traditional M&A activity. Every airline cycle, for example, is accompanied by the loss of certain hubs after the first Gulf War. We lost National as a hub. We lost Raleigh-Durham. We lost San Jose. This time around we have lost Columbus, we have lost another iteration of Raleigh-Durham, and I would suggest going forward, somewhere down the road 5, 10 years, hubs like Memphis, Cleveland and Salt Lake would be on my short list.

Mr. ROACH. Senator, I think that the mergers and acquisitions, first of all, exit to the industry has been very difficult because of less service and Chapter 11, and people could hang on. We show a number of airlines leaving: TWA, American, Banff. There are a lot of airlines and 16 or 17 applications to start new airlines.

We talked about the Social Security crisis, the people not willing to address their problem. We are there in this industry. We are at a crisis in this industry. There is no putting it off until tomorrow. Something has to get done. It has to get done now. Otherwise, we are going to see several more airlines in Chapter 11 before the year is over.

Senator BURNS. The other members have questions, and we'll submit those questions to you for written response, and if you'll copy in the Committee with those responses, we would appreciate that. Thank you for coming today. I think overall we got a pretty good picture of our challenges. We didn't talk about taxes and fees enough, but I think there is some work that the GAO has done, and the information that all of you have given us, especially from Mr. May's office, where I think we are going to take a look at that, and we are going to make an argument for taxes and fees right now are a significant part. I think there is also an awareness now that even in security as the war on terror and as it becomes our enemy, that we can't protect everybody, because Americans are a mobile society. And anything that infringes on that freedom of movement is looked upon as not very good for our society. We are going to have to take a look at our mass transit and our other transportation facilities, one of these days we are going to have to look at the security of this country, and it was suggested up in Montana the other day that we had volunteers.

We decided to send forces in two different ways in World War II to wage that war, and we left our own country vulnerable. And I'm saying we may be in the same situation, but there were voluntary groups, people volunteered to keep our country safe, and for observations and to respond to local emergencies. We may have to go back to that because we cannot, as a government, levy enough taxes to pay for all of it. And so I think you know there are a lot of us up here that are taking a different view of what our priorities are, especially in this area of transportation and keeping it secure.

Thank you for coming this morning. We'll leave the record open for a couple of weeks. If you'll respond to those questions, why, we would appreciate that.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

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